Association of British Insurers

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RISK RETURNS AND RESPONSIBILITY

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The ABI publishes research which explores public policy and other issues relevant to the insurance industry. This report has been written by Roger Cowe, who is a freelance business writer specialising in corporate responsibility, sustainability and social enterprise. He wishes to acknowledge the assistance of Charlotte Turner at Business in the Community, Brian Pearce at Forum for the Future, Peter Montagnon, Richard Taylor, John Hale and Gary Stears at the ABI, and is grateful for the co-operation of CoreRatings, Innovest and SERM. The views expressed are his own and do not necessarily reflect the opinions of these organisations, nor of the ABI. References to CoreRatings, Innovest and SERM are intended to illustrate the development of work in risk measurement but should not be taken as an endorsement of these organisations either by the ABI or the author.

Roger Cowe

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Corporate Social Responsibility: Is There a Business Case (with M Hopkins), ACCA 2003
Environmental Taxes, ACCA 2003
No Scruples? (Editor) Spiro Press 2002 (paperback 2004)
Government's Business – Enabling Corporate Sustainability (with Jonathon Porritt) Forum for the Future 2002

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SUMMARY

- Corporate responsibility has advanced rapidly since the mid-1990s, and especially since the ABI published guidelines on corporate disclosure in 2001, designed to help institutional investors monitor corporate performance. But in general, financial markets have been slow to integrate the concepts into their assessments of risk and returns.
- Companies have responded to the guidelines by beginning to publish useful information for investors, but more is needed from smaller public companies and more focus is required on what is material to each company, rather than general issues.
- Early attempts to gauge the "business case" for corporate responsibility focused on revenue and cost benefits. But there is now greater awareness of the importance of risk as well as returns, including risk to reputation. Social, cultural, demographic and technological changes mean that social and environmental risks are now more significant than in the past and more volatile.
- Growing awareness of the importance of corporate responsibility is a global trend, with significant developments in many markets, including Australia, South Africa and the US. The European Union has taken a close interest and created a Forum to advise on necessary action.
- Three important trends are beginning to make it easier for investors to address these issues:
  - attention to corporate responsibility has spread from a relatively small group of highly-exposed companies through the business world
  - it has begun to penetrate into the core of businesses rather than being concerned with relatively peripheral issues
  - companies have begun to identify issues which are specific to themselves and their sectors
- An emerging set of standards is beginning to build a general approach to reporting on corporate responsibility, but specific impacts are likely to be most important for investors. These will be addressed in the UK in a new Operating and Financial Review (OFR).
- UK pension funds have been encouraged to address social, ethical and environmental (SEE) issues since the amendment to the Pensions Act came into force in 2000, but have been slow to translate statements of principle into specific mandates for investment managers.
- A confluence of corporate governance and socially responsible investing (SRI) has stimulated activity in financial markets. As well as developing analytical skills, investment managers are also collaborating in specific areas, notably climate change.
- Research has shown that incorporating social responsibility can reduce portfolio volatility and increase returns. The evidence is not conclusive, but rejects the view that screening will damage the risk/return performance by narrowing the available investment universe.
- SRI is seen increasingly as an investment style, but one which can add value to other styles such as value or growth.
- Most SRI activity "engages" with companies on their corporate responsibility, rather than screening for companies which meet or fail specific criteria. Evidence suggests that this kind of approach, which integrates analysis of social and financial performance, can yield the best results for equity portfolios.
- These results also apply to bonds and credit ratings.
- So far as underlying corporate performance is concerned, risk aspects of corporate responsibility are as important as bottom line impacts. Companies need to incorporate these matters into strategic risk management, because they can have important implications for drivers such as brand value, market acceptability, human capital and new fields such as biotechnology or nanotechnology.
- Many companies are not yet managing these systemic risks adequately, posing threats to shareholder value which investors need to take into account.

- Many studies have found direct financial benefits for companies embracing corporate responsibility. Although the evidence is not conclusive, it strongly suggests benefits in areas such as corporate reputation, consumer acceptance, employee loyalty and environmental management.
- The benefits are not uniform across all companies or sectors, which makes it more important for investors and financial analysts to understand which companies are most affected and which are most effective at managing corporate responsibility.

INTRODUCTION – THE RISE OF CORPORATE RESPONSIBILITY AND ITS IMPORTANCE TO FINANCIAL MARKETS

Corporate responsibility[1] (CR) has risen rapidly up the agendas of governments, business and the financial world since the mid-1990s. But the broad concept has embraced a variety of ideas and been driven by a range of interests and objectives. As a result, a common understanding has been slow to emerge, especially about the connections between corporate and social objectives and the differences between moral obligations and financial interests.

A consensus has now emerged, in which corporate responsibility is concerned with core aspects of business behaviour – about the way a business makes money, rather than what it does with the profits afterwards (e.g. charitable donations). The UK's minister for CSR, Stephen Timms, has put it like this:

> *"What we are talking about here is beyond philanthropy. CSR is not an add-on. It must be about the very way we do business both at home and overseas."* [2]

This does not mean there has been any dilution in a public company's responsibility to shareholders, which remains paramount. But it recognises that businesses also have relationships with other "stakeholders" and society at large, and shareholder value will be affected if a company neglects these relationships. Value may be destroyed directly, most dramatically through a loss of revenues because of a reputational crisis; indirectly, because of difficulties recruiting people or excessive costs of regulatory compliance; or may be threatened by increased risks to reputation, to licences, or to product acceptability. The converse is that more responsible companies will be able to enhance value by building reputation, by understanding social impacts better and by managing risks effectively. Chief executives have increasingly endorsed CR, concerned about the general decline of trust in business and the potential for impact on their own companies. For example, when asked about the prospects for CR in a potentially difficult economic climate, fewer than one in five of a global sample said that CR and sustainability would have a lower profile[3]. The vast majority said they were actively working on values and ethics in their companies; about three-quarters on operational environmental impacts and employment issues such as diversity; and around half on human rights, work/life balance and product environmental impacts. As the report commented: "More than ever before, CEOs are saying sustainability is an integral part of value creation, not an add-on or a simple cost item".

The World Business Council for Sustainable Development (WBCSD) has drawn attention to the risks and opportunities in the drive for sustainable development[4]. Among the developments it highlighted are:

- new markets from growing populations in developing countries
- the threat from poor health in many of these markets, especially from HIV/Aids
- environmental threats from growing populations and consumption
- the challenge of preserving stocks of fish and other species
- the ageing population in the developed world
- the demand from society for greater accountability and transparency

Business leaders are also concerned about the reluctance of investors to take account of these issues. For example, the World Economic Forum will publish a report[5] on investors and CR in Spring 2004.

Financial markets have generally been sceptical of the potential benefits and risks of CR, typically seeing the growing ethical fund sector as a profitable but insignificant niche and wider issues of corporate responsibility as having little relevance to mainstream

[1] This is the term we have adopted for this report, abbreviated sometimes as CR. It embraces "corporate social responsibility" (CSR), "corporate citizenship" and corporate aspects of sustainable development or sustainability
[2] Speech at Commonwealth Business Council Conference, Chatham House, 2 July 2003
[3] 6th Annual Global CEO Survey, PricewaterhouseCoopers for World Economic Forum 2003
[4] Tomorrow's Markets, WBCSD 2002
[5] Values and Value, Communicating the Strategic Importance of Corporate Citizenship to Investors, World Economic Forum 2004

analysts and fund managers. That scepticism has slowly been eroded, however, as corporate governance scandals have highlighted the importance of integrity and broad management issues, and as greater clarity has emerged about the connections between corporate responsibility and shareholder value in individual sectors and companies.

In 2001, only three per cent of analysts and four per cent of investors volunteered that non-financial factors were important in their judgements of companies (although this rose to nine per cent and 20 per cent when prompted). When asked directly, however, a third of analysts said social and environmental policies were important in helping them assess companies. That was an increase from just a fifth (for environmental policies) and only 12 per cent (for social policies) when the same questions were asked in 1994[6].

This report sets out to address any remaining scepticism by presenting evidence on those connections. We begin with a review of developments in the two years since the ABI published guidelines for companies on the nature of corporate disclosure which institutions expect on social, environmental and ethical (SEE) issues – including the scale of disclosure which has already been achieved.

From the Myners Report and the changes to the Combined Code in the UK to a United Nations statement on companies' human rights obligations, the past two years have seen a torrent of initiatives which have helped companies to understand their responsibilities better and should help shareholders and financial analysts integrate these matters into investment decisions.

In the UK, the government has decided to require leading companies to publish an expanded Operating and Financial Review (OFR) in which directors will report strategic issues, including social and environmental factors which are material for shareholder value.

Section 3 describes the growth of interest in corporate responsibility among trustees and fund managers, followed by a review of the evidence about its impacts, in relation both to investment criteria and underlying corporate performance. A mass of academic and other research has been carried out over the past three decades, and especially since the mid-1990s. We report the most significant evidence, which lends overwhelming weight to the view that:

- investors can enhance risk/return performance through a better understanding of the social and environmental risks companies face and their skills in managing those risks
- companies need to manage social and environmental risks and can enhance long-term financial returns by addressing their particular impacts on society

Techniques for incorporating SEE factors into company analysis and investment appraisal are still relatively new. But specialist firms have emerged to provide the kind of rigorous analytical service which financial markets need. In the final section we describe how two such firms approach this kind of analysis, and report their conclusions on two sectors which do not obviously have high exposures – computer manufacturers and banks.

The analysis demonstrates two important messages:

- in every sector there are social and environmental impacts which present risks and opportunities for companies
- within each sector, there is wide divergence in the extent to which companies are managing these risks

That emphasises why financial markets need to pay more attention to corporate responsibility – all companies are not affected equally, some respond more effectively than others. Clearly, understanding which are most affected and which are most effective presents important investment opportunities.

[6] Investing in the Future, Business in the Community 2001

TWO YEARS OF RESPONSIBILITY RISK DISCLOSURE

The ABI guidelines and companies' response

The Association of British Insurers (ABI) published guidelines in 2001 to help companies understand the nature of disclosure on social, ethical and environmental (SEE) risk which would be helpful to investors (see Appendix). The Guidelines developed from the corporate governance work of ABI members and other fund management firms who were concerned about the management of SEE risks and the ability of investors to assess governance in this field, especially in the light of new pension fund requirements. They concluded that it would be helpful to companies and to investors to identify best practice disclosure and encapsulate that in a set of guidelines. Many companies have responded by including new information in their annual reports. Table 1 (below) shows the level of disclosure according to stock market index groups.

It is clear from Table 1 that the UK's largest companies have embraced the disclosure guidelines with considerable commitment. While more will be expected in future, 80 of the top 100 have already provided at least moderate disclosure. But this commitment is much weaker among the second tier of public companies – half of the FTSE 250 have not achieved even moderate disclosure, while one in six of the All-Share companies have failed to disclose anything on these issues.

The picture varies widely from sector to sector. As might be expected, sectors such as utilities and the extractive industries, which have been most exposed to the risks have seen the highest levels of disclosure. In the utilities sector, 91% of companies have made at least moderate disclosure. On the other hand, only eight per cent of distributors and nine per cent of IT services companies have achieved this level.

In this context, "full disclosure" means that a company has met the requirements of the ABI guidelines. In particular, it has covered SEE in its report and accounts, including:

- defining board responsibilities and management processes
- identifying risks, their business impact, policies and procedures in place to deal with them
- disclosing performance and targets for quantifiable risks
- internal or external verification or audit

TABLE 1: 'SEE' DISCLOSURE FOR YEAR ENDS DURING 2003

	FTSE 100	FTSE 250	FTSE All-Share
Full disclosure	23	2	6
Moderate disclosure	57	46	35
Limited disclosure	20	41	41
No disclosure	0	11	18

Figures show percentage of companies in each disclosure category for each FTSE grouping

The figures in the table relate to the second year for which the guidelines have applied. As expected, the level of compliance increased significantly between the first and second years. Smaller companies also exhibited increased awareness in the second year, even though their commitment still lags behind the top 100.

The figures refer to the extent rather than the quality of disclosure, however. The ABI is aware that some companies may be doing little more than going through the motions for the sake of compliance or to avoid the attentions of pressure groups. This might be evidenced by companies commenting on an issue which generally has a high profile, such as water use, even though this may not be a significant issue for the company concerned, which may be much more exposed to something such as supply chain risk.

The purpose of the guidelines was to encourage companies to identify risks (and opportunities) which are most significant for them, not to address a standardised agenda. Investors need to know what boards believe to be their main exposures, and how they are dealing with those issues, as in the case of BT (see Box 1) which clearly set out its SEE risks in the corporate responsibility section of its annual report. Many companies have not yet reached this point, which means they are not providing investors with the information they need to make informed judgements. This shortcoming may be addressed when companies have the benefit of guidance on materiality (see UK Company Law and the Operating and Financial Review section commencing on page 14).

BOX 1: BT'S RISK STATEMENT

BT: extract from "Our commitment to society" section of annual report 2003
Social, environmental and ethical risks

Currently, we identify no social, environmental or ethical risks that would have a material impact on our business.

However, we have identified the issue of supply chain working conditions as posing a potential risk to our reputation. In order to address this potential risk, we have introduced our Sourcing with Human Dignity programme – a collaborative undertaking seeking the active support of all our relevant suppliers.
By 31 March 2003, 16 key suppliers (79% of those targeted) had signed an agreement with BT giving their written support concerning ethical trading.

Over the past two years, 16 initial on-site assessments and seven re-visits have been undertaken in industry sectors where we believe the risk of falling short of our Sourcing with Human Dignity standard is at its highest.

BT's certification to ISO14001 includes an environmental risk assessment process and the bulk storage of diesel fuel for use in back-up generators at telephone exchanges has been identified as our only significant environmental risk.

Although there are a small number of BT sites where ground remediation is taking place, the cost is not material and so we declare no material contingent environmental liability in our financial statements. In order to minimise any future liability in this area, we are undertaking an £18 million programme to cover tank testing, enhanced maintenance scheduling and remedial works.

Developments in corporate responsibility

General trends

In the two years since the ABI guidelines were published the momentum behind corporate responsibility has continued to build, driven by renewed concerns about corporate behaviour as well as a growing acceptance that businesses need to be open about their operations and demonstrate their beneficial impacts on society.

Levels of trust in business have continued to fall, stimulated by the corporate governance scandals at companies such as Enron and Ahold. Almost two-thirds of British adults do not trust business leaders[7] in general and 80% say they cannot trust directors of large companies simply to tell the truth. Over 60% of the public say big business doesn't care about their social and environmental impacts. This is a global phenomenon, but especially marked in Europe, where NGOs are now much more widely trusted than business or government[8].

Interest in corporate responsibility has spread widely, illustrated by the fact that in the UK more than 130 MPs have now joined the all-party group on the subject. In the financial world, the FTSE4Good indices were launched in 2001, including only companies that meet minimum standards for environmental performance, human rights and stakeholder relationships. City professionals expect the trend to continue growing – a survey of fund managers and analysts across Europe found just over half agreeing that social and environmental considerations would become part of mainstream investment analysis within three years[9].

Interest has been driven by and has stimulated a stream of developments and initiatives in the fields of corporate responsibility and sustainability. Specific developments of note are detailed later in this section.

There are three general trends:

- Corporate responsibility has spread through the business world. It is now seen as affecting every significant business and not just those exposed to particularly controversial issues (e.g. oil companies such as BP and Shell, brands such as Nike and Gap with developing country supply chains). It is also a global phenomenon, with increasing activity in all regions.
- It has begun to penetrate into the core of businesses. Rather than being widely seen as a peripheral activity concerned primarily with community support, companies are now recognising that the most significant responsibility issues concern their core business activities – products, marketing, business strategies.
- Companies have begun to identify issues which are specific to themselves and their sectors. This follows from the previous trend, as issues stemming from core business activities are bound to be determined primarily by those specific activities. For example, while all companies operating in oppressive regimes need to be concerned about human rights, an issue such as social exclusion is bound to be more pertinent in sectors such as financials and utilities than in autos or electronics. Similarly, retailers' most significant environmental impacts are indirect (stemming from product purchasing and customer behaviour), contrasting with the direct impacts of chemical companies and major manufacturers.

The result of these trends is that while all companies face a set of generic risks, sector-specific factors may be more important than any of these. Generic issues, which are significant in many sectors, are typically covered in codes and guidelines such as the UN Global Compact and the OECD Guidelines for Multinationals. The main issues covered by such codes are:

- treatment of employees, including workers in the supply chain, embracing issues such as diversity, health and safety, as well as pay and conditions (especially in developing countries) and child labour

7 MORI Trust Monitor 2003
8 Edelman survey on trust and credibility 2003
9 Investing in Responsible Business, CSR Europe, Deloitte and Euronext 2003

- human rights issues such as torture, political imprisonment in countries where a company has a significant presence; also bribery and corruption
- environmental impacts, including sourcing of materials and products, product use and disposal
- community impacts, including explicit support for community organisations but also the impacts of sourcing and employment practices and the economic impacts of location decisions
- transparency – openness to and engagement in dialogue, as well as public reporting of performance in these areas

These generic issues often fail to capture the core responsibility issues which are most significant for many companies and which may present bigger risks or opportunities than the "standard" checklist covered above. Examples of such issues which affect several sectors are:

Social exclusion – disadvantaging sections of the community by retreating from or failing to serve economic or geographic markets. Banks have come under particular scrutiny for this, especially when closing branches but also over the provision of "basic" accounts suitable for people who have previously been refused banking services because of their limited resources and/or poor debt records. Other financial companies (e.g. insurers) are also exposed to this risk, as are retailers, although the issue has not yet become prominent in that sector. Utilities also have to deal with the issue, especially in the form of "fuel poverty". On a bigger scale, it is also relevant to the pharmaceutical industry, especially in connection with access to drugs, especially HIV drugs in Africa.

Excessive consumption – encouraging or failing to discourage customers from buying more product or service than they can reasonably afford or more than is good for their health. Alcohol, tobacco and gambling are particular examples of this which have been recognised for many years. They are now joined by "unhealthy" food which is complicit in obesity. But the issue of "over-marketing" is also relevant to other sectors, especially where vulnerable consumers are concerned who may fall into unmanageable indebtedness through over-consumption– e.g. mobile phones, cable and satellite TV, and the financial services industry (especially credit card providers). With the rise of attention on the concept of sustainable consumption, this issue could become relevant to all consumer sectors, including media and advertising.

Fair trade – the term is usually associated with niche companies which provide a premium for growers in developing countries, e.g. CafeDirect. But the question of terms of trade is increasingly relevant to mainstream buyers, especially of agricultural produce, for example the branded coffee and chocolate manufacturers and food manufacturers generally. It is also relevant to domestic suppliers. For example, supermarkets have come under attack for the terms and conditions of their purchases from UK farmers.

Recent research[10] has identified the need for companies and investors to focus on material (rather than general) business risks, and identified several sectors where even traditional social and environmental issues may not cover important emerging issues which may be material for shareholder value:

TABLE 2: EMERGING ISSUES

Sector	Traditional issue	Emerging issue
Oil and gas	Oil spills CO_2 emissions	Socio-economic impacts Host government relations and revenue sharing
Food manufacturing	Food safety Brand and reputation risk	"Functional food" regulation Nutritional value, especially in low income diets
Pharmaceuticals	Bio-safety Animal welfare	Role re national healthcare systems Patent rights Environmental effects of compounds
Automotive	Safety requirements CO_2 emissions	Mobility and socio-economic impact Low emission regulations

Source: Speaking the Same Language, Arthur D Little

Corporate governance and corporate responsibility

The corporate governance scandals, mainly in the US, at companies such as Enron and WorldCom, brought together the previously separate strands of corporate governance and corporate responsibility. They emphasised the dangers of unethical behaviour and the need for responsible policies and practices to penetrate throughout a company. The collapse of Enron's auditor Arthur Andersen also highlighted the fact that reputation is not just an important asset, but one which can be critical to the survival of businesses which have few physical assets, especially in the service sector where customers are frequently buying values and judgements as much as tangible service.

The Sarbanes-Oxley Act, which emerged from the Enron debacle in the US, introduced some boardroom measures similar to existing UK requirements – e.g. certifying accounts and audit committee arrangements. There were many detailed requirements concerning accounting and relationships between companies and their auditors, but its main import was perhaps to bring home the message that responsible behaviour is about what a company actually does, not what its policies say – important for broader corporate responsibility. The point was well made by Richard Breeden in his report on corporate governance failures at WorldCom. He observed:

> *"It is worth noting that persons engaged in wrongdoing may often indulge in frequent prayer, and expressions of dedication to integrity, all without meaning. Flowery words expressing adherence to the highest standards of integrity are relatively easy to write, but it is deeds, not words, that count."*

The UK's response to the American scandals emerged in the Higgs report. It also focused predominantly on boardroom practices, and especially the requirements for non-executive directors, and led to changes in the Combined Code.

[10] Speaking the Same Language, Arthur D Little for Business in the Community 2003

Neither of these major corporate governance initiatives dealt specifically with the wider area of corporate responsibility. But they have had an important impact on relations between companies and their shareholders. The concept of "engagement" with companies on issues of concern to institutions – which has been an important plank of the responsible investment community – has been endorsed especially by the Higgs report. This supports earlier calls by Paul Myners for greater shareholder activism to ensure proper scrutiny of company boards and the discharge of shareholders' ownership responsibilities.

The Institutional Shareholders Committee (ISC) updated its principles[11] for pension funds, insurance companies, other institutions and their fund managers. The ISC called on fund managers to be more active in relation to their investments:

- clarify the priorities attached to particular issues and when they will take action
- monitor the performance of, and establish, where necessary, a regular dialogue with investee companies
- intervene where necessary
- evaluate the impact of their activism
- report back to clients/beneficial owners

A company's inadequate approach to corporate social responsibility is specifically identified in the guidelines as a reason for intervention.

South Africa has gone furthest to integrate broad responsibility issues into its corporate governance framework. The second report from the King Commission, known as King II, specifically identified social and environmental responsibilities, arguing:

> *"successful governance in the world in the 21st century requires companies to adopt an inclusive and not exclusive approach. The company must be open to institutional activism and there must be greater emphasis on the sustainable or non-financial aspects of its performance. Boards must apply the test of fairness, accountability, responsibility and transparency to all acts or omissions and be accountable to the company but also responsive and responsible towards the company's identified stakeholders."*

The report called on companies to report annually on non-financial matters. In the South African context, HIV/Aids and black empowerment were specified, but the report also asked for reporting on social, ethical, safety, health and environmental management policies and practices.

Corporate responsibility developments around the world

Britain has been in the lead in many corporate responsibility developments, but several other countries have also pursued a similar path and in some cases have gone further. For example, France and Denmark require corporate reporting on social and environmental performance. The UK pensions requirement for trustees to address SEE criteria has been copied in Germany, France, Belgium, Sweden, Denmark and Australia. In fact, Australia's Financial Services Reform Act requires all investment firms' product disclosure statements to include descriptions of the extent to which they take account of environmental, social, ethical and labour standards – and to specify how they do it.

The European Union has taken a close interest in corporate responsibility. The private sector's social obligations were specifically identified as part of the "Lisbon agenda" aimed at making Europe both competitive and socially inclusive. A formal Communication issued in 2002 suggested that this should remain a voluntary process, despite a call from the Parliament for compulsion in areas such as reporting. The Commission set up a Multi-Stakeholder Forum to consider suitable developments. It will report back in the summer of 2004.

The Commission has also backed an Academy consisting of academics and practitioners to develop research in and teaching of corporate responsibility, especially in business studies and MBA courses. Leading business schools backing the Academy include Insead, London Business School and ESADE in Spain.

[11] The Responsibilities of Institutional Shareholders and Agents – Statement of Principles, ISC 2002

As already noted, South Africa has been particularly active in integrating social responsibility concepts in its corporate governance framework. The Johannesburg stock exchange now requires all listed companies to comply with the King II code, which includes social and environmental reporting based on the Global Reporting Initiative (GRI). The exchange is also launching a sustainability index, to include companies judged to be leaders in social, economic, and environmental sustainability and corporate governance, a South African version of the Dow Jones Sustainability Indices which were launched in 2000.

In Asia, developments have been driven by a combination of local concerns and the needs of western multinationals to ensure acceptable conditions in their suppliers' factories. This combination can be highly effective in exposing bad practice, as one author recently noted:

> *"Long before the revelations of accountancy fraud, Enron's reputation had already been tarnished in the corporate responsibility world by the extensive criticisms of its deeply flawed power station project in Dabhol, for infringements of community rights and corrupt contracting practices."*[12]

The Johannesburg Summit on sustainable development in 2002 demonstrated the extent of involvement of leading multinationals in social and environmental policy issues. It also reinforced the need for companies to respond to pressures for transparency, and the Summit's statement of aims included promoting corporate responsibility and accountability, through existing agreements such as the UN's Global Compact and the OECD Guidelines for Multinationals. The Summit also emphasised the urgency of action on the key objectives of water, sanitation, health, biodiversity and energy.

In November 2003, the United Nations convened a "summit" of institutional investors in the US controlling more than $1 trillion in assets, including several state and city treasurers, to debate climate change. They set up an Investor Network on Climate Risk and issued a 10-point "call for Action", including:

- the SEC to enforce corporate disclosure of climate change risks
- companies in major greenhouse gas-producing sectors (e.g. autos, power utilities) to report to shareholders on the financial implications of climate change – including regulation and competition
- investment managers to include climate change in their analyses

Company reporting and analysis

In the UK, as in most countries, social and environmental reporting remains voluntary, although there has been a vigorous campaign to make it mandatory. A coalition bringing together NGOs such as Amnesty UK, Christian Aid and Friends of the Earth promoted the CORE Bill, which was adopted by Labour MP Linda Perham and received the backing of more than 300 MPs.

The number of companies voluntarily publishing social and environmental information (not specifically relating to the ABI guidelines) grew dramatically between 2001 and 2004. Many produced standalone reports, while others incorporated information in their annual reports. Others did both, with additional detailed information available on company websites.

In the UK, only six of the FTSE100 say nothing about these issues, and less than half of the top 250 quoted companies, although many (especially outside the FTSE 100) do not produce a special report[13]. Worldwide, more than 600 companies have published hard-copy reports in each of the last two years[14]. Roughly half of them now refer to an emerging standard for such reports developed by a UN-backed venture bringing together business, NGOs and experts, known as the Global Reporting Initiative (GRI).

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[12] The emerging South Asian Agenda, Ritu Kumar, in Something to Believe In, Greenleaf Publishing 2003

[13] Directions3, Trends in CSR Reporting 2002-3, Context Group and SalterBaxter

[14] corporateregister.com

The GRI has developed a set of indicators which help companies to produce useful reports by identifying the issues which are of most interest to users. In an attempt to narrow the basket of indicators and make reporting more relevant, the latest version of the GRI guidelines, published in 2002, identifies a set of generic measures and others which may be specific to individual sectors. Generic indicators are shown in Box 2. The organisation is now working on sector-specific guidance.

BOX 2: GENERIC INDICATORS FOR CORPORATE RESPONSIBILITY REPORTING IN THE GRI GUIDELINES

Economics: sales analyses, including significant market shares; cost analyses, including payments to employees, distributions to providers of capital and returns on capital, distributions to and subsidies from governments, distributions to community organisations and "civil society".

Environment: materials, energy, water use, biodiversity impacts, emissions and waste, impacts of products or services, non-compliance with regulations.

Social issues: employees and labour relations, health and safety, training and education, human rights, community impacts, bribery and corruption, political lobbying and donations, non-compliance with regulations.

In the UK, Business in the Community (BItC) has developed a similar set of indicators, many of which overlap with those in the GRI guidelines. But it has gone further to address the difficulty of using company information to rank companies in terms of corporate responsibility. The annual Corporate Responsibility Index was produced by BItC for the first time in 2003. Modelled on the organisation's established environmental index, it places participating companies in quintiles (or divisions) based on their (self-reported) management processes and performance. The index proved highly controversial, not least with those in the bottom quintile, but it illustrates the trend to using information on corporate responsibility to rank companies.

The complexity of making such judgements in such a broad area has encouraged others to focus on individual sectors. For example, Sustainability Asset Management, the Swiss company behind the Dow Jones Sustainability Indices, and the World Resources Institute in the US, jointly produced an assessment of how action to mitigate climate change will affect the global auto industry[15]. They concluded that the impacts would vary widely from company to company. Costs of meeting carbon constraints were estimated to range from $650 per vehicle for BMW to less than $25 per vehicle for Honda. The earnings impact between 2003 and 2015 is estimated to vary from 8% positive (for Toyota) to 10% negative (for Ford).

Similarly, institutions such as J P Morgan have assessed the impact of the European Union's carbon emissions trading scheme (which begins in 2005) on the European utilities sector[16]. Again, the analysis concluded that the impacts would vary widely across the industry. Scottish & Southern and Iberdrola are best placed, while RWE and Union Fenosa are likely to be most affected. The research also concluded that accounting treatment of trading activities would result in higher earnings volatility.

More ambitiously, a collaborative project has developed metrics for assessing the overall corporate

[15] Changing Drivers: The Impact of Climate Change on Competitiveness and Value Creation in the Automotive Industry 2003

[16] Global Utilities Partner, J P Morgan November 2003

responsibility performance of the supermarket sector. The project[17] was hampered by the non-participation or withdrawal of the leading chains, but developed performance indicators in seven areas:

- environment
- producers
- workers
- local economies
- nature
- animals
- health

Such developments illustrate the benefits of taking a sectoral approach to assessing corporate responsibility, as well as the need to do so to focus on the key issues for business performance rather than broad issues which may not have great significance for shareholder value. Several organisations are now adopting this approach, including the research organisation EIRIS (Ethical Investment Research Service), which has assessed the banking sector's social and environmental performance. It concluded that The Co-operative Bank was the best overall, while Abbey, Barclays, Lloyds TSB, Northern Rock and RBS were in the top rank. Just Pensions, an organisation which aims to stimulate pension funds' responsibility activity, has begun a series of sector studies providing guidance for pension fund trustees, beginning with the pharmaceutical, utilities and media sectors.

Codes and standards

Judging how well companies perform in this area is complicated by the absence of a ready measurement currency, but also by confusion about the standards which companies are expected to meet. This has not been helped by the plethora of codes, but the last couple of years has seen some consolidation around a key set of standards and mechanisms for assessing performance against them.

A recent book[18] describes almost 30 codes or statements, ranging from the Sullivan Principles which many US multinationals have adopted, to the Sigma Guidelines for integrating sustainability in management systems, published in October 2003 by the UK Department of Trade and Industry. Many have been developed jointly by business, government and NGOs. Some are global, promoted by global agencies such as the OECD and UN; others are national or regional, or concerned with specific industries. Industry codes such as the 2003 Equator Principles (project finance) and the cement industry's 2002 Agenda for Action may help to identify leadership companies in their sector and provide them with a basis for competitive advantage. Key cross-sector examples are:

The OECD Guidelines for Multinationals – updated in 2000 and increasingly seen by corporate, investor and NGO communities as a valid set of broad principles. Importantly, while the Guidelines are voluntary they provide for "national contact points" in each OECD member government, which can receive and act on complaints against individual companies. These officials may increasingly bring informal pressure to bear on companies which breach the guidelines.

UN Norms on human rights responsibilities of companies – distilling the Universal Declaration of Human Rights, many other treaties, conventions and key standards promulgated by the International Labour Organisation. This document, agreed in 2003, provides a clear, concise explanation of what is expected of companies in the fields of security, equality, consumer and environmental protection, bribery and similar aspects of the broad human rights agenda. A group of companies describing itself as the Business Leaders Initiative on Human Rights has endorsed the norms and identified necessary corporate action. It is chaired by the former UN Commissioner Mary Robinson, and includes Barclays, National Grid Transco and Body Shop from the UK.

SA 8000 – a labour standard focusing on management systems and including independent certification, used by factories to certify that they operate humanely, and by buying companies to try and ensure acceptable standards in the factories where their clothes, toys etc

[17] Race to the Top, co-ordinated by the International Institute for Environment and Development
[18] The Corporate Responsibility Code Book, by Deborah Leipziger, Greenleaf Publishing 2003

are made. Almost 300 factories had been certified in autumn 2003, across 36 countries (led by Italy and China) covering nearly 200,000 workers.

Accountability 1000 – a framework developed by the UK-based institute known as Accountability, setting out best practice processes for reporting on social and environmental issues. In 2003, it was supplemented by a separate standard covering auditing of such reports. These two documents are important because they set out processes for rigorous reporting and auditing in this field. Together with the Global Reporting Initiative, they provide the basis for assessment and analysis of corporate responsibility performance.

Industry sectors have begun to develop specific initiatives for their own sectors, ranging from the chemical industry's long-standing Responsible Care scheme to the extractive industry's agreement on bribery and transparency. In the UK, the financial sector has developed the Forge guidelines to help companies address industry-specific environmental and social issues. The key issues identified in Forge are shown in Box 3.

BOX 3: FINANCIAL SECTOR ISSUES IDENTIFIED IN FORGE GUIDELINES

Workplace	Marketplace
Disciplinary practices Work/life balance Health and safety Learning and development Diversity and equal opportunities Freedom of association/collective bargaining Forced/child labour in client companies Bullying and harassment	Access to products and services Advertising and pricing Business ethics Customer services Privacy Terms of trade Supplier relationship Value of products and services
Environment	**Community**
Materials consumption Waste management Transport Property design and management	Involvement in the community Investment in the local community Human rights risks from investments Indigenous rights

UK Company Law and the Operating and Financial Review (OFR)

The government is introducing a mandatory requirement for an expanded OFR in the annual reports of the largest UK companies (roughly the top 1,000 public and private businesses). It will be based on that already required by accounting standards but expanded to include broader strategic issues and to be more forward-looking. As the Secretary of State for Trade and Industry, Patricia Hewitt put it: "so our largest businesses report fairly and transparently on

the factors which affect them, including their impact on the environment and society where relevant."[19]

The concept emerged from a wide-ranging review of company law by an independent group led by the Department of Trade and Industry, which was translated into a White Paper[20] in 2002. But the requirement for the new OFR will be introduced using existing Companies Act powers. It could affect company reports as early as 2005.

The White Paper endorsed the review's conclusion that company directors should consider long-term issues as well as short-term, and broad matters such as "their relationships with their employees and the impact of the business on the community and on the environment". Similarly, the OFR is intended to allow readers to understand company strategy, performance and prospects on such subjects (as well as more conventional areas). Directors are left to judge which specific issues are sufficiently material to include in the report, but the White Paper says they must consider whether to include information on anything which might affect the company's reputation, as well as policies and performance on employment, environment, social and community issues.

This approach should produce more meaningful information than a standard template, but it is more difficult for boards to implement because they need to decide what is material for their own circumstances. Directors will also naturally be concerned with potential liabilities arising from reporting or non-reporting. It is, therefore, important for boards to understand the kind of process they should follow in deciding material issues which should be reported.

A special committee chaired by the economist Rosemary Radcliffe (who had been a member of the Company Law Review Panel) deliberated during 2003 on how companies should judge materiality in the context of social and environmental matters, and consulted widely on the appropriate process. The committee developed principles on materiality in this context, and set out the process which boards would need to go through to make their judgements.

It began by suggesting that while the OFR, like the rest of the report and accounts, is formally addressed to shareholders, it also needs to take account of other relationships. Citing the potential impact of an environmental project on company reputation, the group observed:

> *"A key objective of the OFR is to strengthen accountability, including accountability for the way in which such issues are managed. So the key question in deciding whether or not an item is material should be: "Does this item matter to the members, either directly, or indirectly as a result of its significance to other stakeholders and thus to the company?"* [21]

The report also recommended that companies seek external validation to aid their judgements, e.g. consulting stakeholder groups to improve their understanding of what others see as being important to the company's prospects. It cited several emerging standards as examples of external guidance on what is generally considered to be material. They include:

- the Global Reporting Initiative
- Indicators that count, published by Business in the Community
- guidelines on environmental reporting published by the Department for Environment and Rural Affairs
- the AA1000 Assurance standard
- the OECD Guidelines for Multinationals
- the Report of the Taskforce on human capital accounting

Reporting on social and environmental issues in the OFR may take a little time to develop, but the requirement will introduce much-needed rigour into companies' reporting on such matters. It will also provide analysts and others with a useful starting point to consider social and environmental risks and opportunities.

[19] Speech July 10 2003
[20] Modernising Company Law
[21] The Operating and Financial Review Working Group on Materiality consultation document

CORPORATE RESPONSIBILITY AND THE CITY

The City has watched the growth of corporate responsibility with a certain amount of scepticism. Nevertheless, CR has made gradual inroads into the investment world as the evidence has mounted that integrating social and environmental factors into investment strategies can yield benefits for investors.

The next section describes that evidence, while this section reports developments in socially responsible investing (SRI) in the past few years.

Pension funds

Following an amendment to the Pensions Act which came into effect in 2000, trustees are now required to include in their annual Statement of Investment Principles (SIP) comment on the extent to which (if at all) their investment decisions take account of social, environmental and ethical issues. Research has shown that many trustees have responded positively to this requirement. Almost £90 billion of pension funds' UK equity holdings are now subject to some form of socially responsible investment policy, equivalent to almost a quarter of the sector's total UK holdings[22].

This figure is based on SIP statements, but in many cases it appears that the inclusion of SEE issues in a SIP may have made little practical difference to investment practice. At the end of 2002, the research organisation EIRIS polled the top 250 UK pension funds. Of the 70 responses (mostly from the private sector) 90% said their investment strategy did take account of SEE factors. EIRIS observed: "It is one thing to say you incorporate SRI into your fund's investment strategy, but quite another to implement this policy."[23] But the responses to the research suggested substantial activity:

- 59% of funds said they consider SRI experience and performance when appointing or re-appointing investment managers
- 54% of the funds' pensions managers/trustees have received training on incorporating SEE issues into investment strategy
- 59% said they have asked their investment managers to consider the financial implications of SEE factors when assessing the risk and returns of each company
- 11% undertake some form of screening and/or preference weighting in relation to SEE issues
- 87% say they exercise voting rights on SEE grounds

These figures suggest there is more knowledge and interest in SEE matters among pension trustees than is evident from mandate awards made specifically on SEE grounds. The picture which emerges is of trustees concerned about SEE criteria, but relying largely on fund managers to take the initiative.

Another piece of research suggested strong interest, especially among member trustees. It was carried out by Ashridge for the organisation Just Pensions, in co-operation with the TUC, and found fairly strong beliefs in the importance of SEE issues, but mainly in the medium to long-term.

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[22] Socially Responsible Investment among European Institutional Investors 2003 , Eurosif

[23] How Responsible is Your Pension? EIRIS 2003

TABLE 3: MEMBER TRUSTEES' VIEWS ON LIKELY IMPACTS

	Percentage Saying Impact Will Be:			
	Substantial	Some	None	Don't know
Long-term impact on stock market value from:				
- good employment practices	30	52	14	4
- social/environmental transparency	23	54	18	5
- effective environmental management	20	62	12	6
- respect for local needs in developing world	11	50	31	8
Impact of pension fund activism on corporate behaviour within:				
- 1 year	0	26	62	12
- 3 years	6	59	22	12
- 10 years	37	48	5	9

Source: Will UK pension funds become more responsible? Just Pensions 2003

Some funds have been particularly active in pursuing corporate responsibility, notably the Universities Superannuation Scheme (USS) which has recruited a team of specialists. In the public sector, many funds have joined together in the Local Authority Pension Fund Forum (LAPFF), which has assets of more than £40 billion. It has run campaigns to improve corporate performance on overseas labour standards and environmental issues.

The Institutional Investors Group on Climate Change brings together 19 funds with assets totalling £450 billion (including some fund management groups) to focus on investment risks and opportunities in this area. It has produced reports[24] on aviation and power generation, analysing the investment issues from a move to a low-carbon economy. In both cases the analysis concluded that the sectors would be significantly affected, and that the impacts would vary significantly from company to company, with obvious implications for sector weightings and stock selection. In aviation, the low-cost airlines would be hardest-hit, potentially losing 80% of current profits. In the power sector, Scottish and Southern and E.ON were seen as winners because of their relatively low carbon intensity.

Fund managers

Apart from requests by pension fund clients, fund managers' growing interest in corporate responsibility has come from two quite different directions. First, the ethical investment tradition (e.g. at Jupiter, Henderson, ISIS, Morley, CIS) has developed research skills. A second strand has seen institutions which focused on corporate governance (e.g. Hermes, Barclays Global Investors, Schroders) develop that concern into broader corporate responsibility. Others, such as Insight Investment Managers (HBOS), have come to this area afresh and used both sets of expertise to integrate corporate responsibility in their investment approach. Some houses do not apply broad corporate responsibility policies but act on specific issues such as climate change. Together, all these players constitute what can be called the Socially Responsible Investment (SRI) industry.

Ethical funds have continued to attract substantial retail funds, easily outpacing inflows to other funds. The total now invested according to ethical criteria is $2.2 trillion in the US and €12 billion in Europe[25] Nevertheless, this is a small proportion of the total stock market and an insignificant presence on most companies' share registers.

[24] Climate Change and Aviation/Climate Change and Power Generation
[25] Social Investment Forum (US) and SiRi (Europe)

Much more significant is the engagement approach adopted by the main SRI houses. Drawing on corporate governance practices, firms take up social and environmental issues which have implications for the shareholder value of companies they are invested in. Since they speak on behalf of their total investment, not just screened ethical funds, this means:

a) that the engagement can be backed by a significant shareholding in the company

b) that it applies to all sectors, including those such as tobacco and alcohol, which are not generally held by ethical funds

More than £200 billion of assets were subject to engagement strategies at the end of 2001[26]. The mainstream engagement approach is typified by the investment principles adopted by Hermes. Two of its 10 principles refer to social, environmental and ethical matters:

- Principle 9: 'Companies should manage effectively relationships with their employees, suppliers and customers and with others who have a legitimate interest in the company's activities. Companies should behave ethically and have regard for the environment and society as a whole.'
- Principle 10: 'Companies should support voluntary and statutory measures which minimise the externalisation of costs to the detriment of society at large.'

Collective action

Increasingly, investors are working together on issues of common concern, most notably climate change. The Carbon Disclosure Project has brought together 87 international investors, speaking for $9 trillion of assets, to press the world's 500 largest companies to publish their greenhouse gas emissions data so that investors can judge their exposure to climate risk.

[26] SRI: A Global Revolution. Russell Sparkes, 2002, John Wiley & Sons
[27] Investing in the Future, Business in the Community, 2001

Institutions backing the project include AXA, BNP Paribas, Credit Suisse, HSBC, Merrill Lynch, UBS and Wells Fargo.

Collective action has also been seen in relation to individual companies (e.g. shareholder resolutions at BP) and on specific issues such as Burma, where a group of eight investors issued a joint statement at the end of 2001 warning about the dangers for shareholders of companies operating in the country. They drew attention to the business risks and called for companies to promote human rights and publish social impact assessments.

Investors have also worked together on specific sectors such as the extractive industries and pharmaceuticals. A dozen institutions have joined together to form the Pharmaceutical Shareholders Group, with a joint secretariat, to address common concerns, mainly connected with the issue of access to medicines.

Analysts

On the whole, mainstream equity analysts have shown relatively little interest in corporate responsibility. They have tended to regard the issues as having little relevance to earnings forecasts and shareholder value – in the timescale which mainly concerns them, i.e. the coming two or three years. This relative lack of interest is fuelled by a communication "Catch 22" – companies frequently say they do not raise CSR issues with analysts because analysts never ask about them; analysts say they don't ask because companies never raise the issues.

This situation has changed, slowly, since the mid-1990s when corporate responsibility began to grow. One in three sell-side analysts now say they believe social and environmental issues are important in evaluating companies[27]. This compares with 1 in 5 (for environmental issues) and 1 in 8 (social issues) in 1994.

Some firms have taken specific steps. For example, UBS has contracted the CR specialist firm Innovest to train staff on environmental issues. HSBC and

Dresdner Kleinwort Wasserstein have employed specialist staff to stimulate awareness and understanding of corporate responsibility among their equity specialists and clients. And in some sectors which will be significantly affected by current developments, analysts have begun to take social and environmental issues into account in their analysis, e.g. utilities, where several analysts[28] have published reports on the impacts of climate change and the European Union's emissions trading scheme.

Specialist firms have also emerged to provide analysis and ratings of companies' exposure to social and environmental risks and opportunities. Ethical Investment Research Service (EIRIS) now has 20 years' experience in corporate responsibility research. Other firms combine the SEE research skills, which have developed from the ethical funds movement, with the business understanding and rigour expected of financial analysts. Examples of their approach and work are included in section five of this report. Individual research firms have also developed collaborative networks which mean that global coverage is now available. For example, Sustainable Investment Research International (SiRi) organisation (which includes PIRC in the UK) was recently established formally as a company.

[28] e.g. UBS, HSBC, Citigroup Smith Barney, CSFB, JP Morgan

THE EVIDENCE

Investment risk and returns

The implications for investors of incorporating SEE criteria are not clear-cut. As with many investment issues, a mass of studies have failed to prove conclusively the likely impact on risk or returns. But the weight of evidence is clearly against the theoretical view that investors will suffer increased risk and/or lower returns by adding criteria which are not solely financial. On the contrary, the evidence suggests that SRI is likely to be less volatile and can result in higher returns than a traditional approach.

Lower share price volatility was found in studies by the Institute of Business Ethics[29] and by City University[30] (now Cass) Business School for Business in the Environment (BiE), the business-led environmental campaign. Examining companies from the BiE environmental index, the study correlated the rankings in the index with share price performance. It found there was slight (but not statistically significant) underperformance by the high scorers in the environmental index. But there was a significant difference in share price volatility between these environmental leaders and the low-scoring companies.

Like most studies in this field, there are caveats to any conclusions, because there are several difficulties in attempting to identify what can be described as the "SEE effect" in any such research:

- the research evidence is mostly concerned with screened portfolios, but mainstream SRI is not about screening companies in or out of portfolios. Instead, it is about taking account of the extent to which corporate strategies and risk management approaches include social and environmental factors
- while it is easy to measure the performance of SRI investments against benchmarks, the comparisons may be invalidated by different weightings which are a consequence of the SRI approach. For example, US SRI funds have typically been overweight in technology stocks and in smaller companies
- timescale is a problem – few funds which apply engagement strategies have a track record which goes back beyond the late 1990s bull market, so many comparisons are based on the recent boom and bust period, which is far from typical
- to some extent this kind of exercise is circular – the fact that the stock market has not generally valued sustainability attributes inevitably means that the share price performance of the most sustainable companies will not be as good as it would be if these factors were more highly valued by the market. These companies can only outperform if they can demonstrate attributes which are more highly valued by the market, essentially short-term financial performance or prospects

Nevertheless, the research does challenge the conventional wisdom that screening will increase volatility and sub-optimise returns (because of the smaller available investment population). Increasingly, SRI is seen as just another investment style, analogous to selecting for attributes such as growth, value, technology, or emerging markets.

Much of the available analysis has been carried out on US social and environmental funds, especially the Domini Social Index. One study summarised 95 analyses and found those which discovered a positive correlation between screening and financial returns outweighed those with negative findings by a factor of 10[31].

Recent research from the Wharton School at the University of Pennsylvania appears to challenge such a positive view[32]. One of its conclusions was that investors who opt for managed SRI funds could lose out by as much as 3.7% per annum. However, this shortfall relates more to fund choices and individual

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[29] Does Business Ethics Pay? Webley and More, Institute of Business Ethics 2003

[30] Emerging Relationship Between Financial and Economic Performance, Business in the Environment 2002

[31] Margolis and Walsh, People and Profits - The Search Between a Company's Social and Financial Performance, Lawrence Erbaum 2001

[32] Investing in Socially Responsible Mutual Funds, Geczy, Stambaugh and Levin, 2003

fund performance than to the SRI "style". In fact, the authors found that investors who opted for SRI index funds (such as Domini) would fare little differently to those who chose non-SRI index funds – a loss of 0.5% per annum. The more significant losses came from choosing active management in particular styles, e.g. value, for which there is a much smaller choice of SRI funds. These results were also criticised for using inappropriate comparisons. Many of the comparator portfolios included funds which were not available to ordinary investors, and some property rather than equity funds.

The majority of studies of share price (rather than fund) performance have not found that socially responsible investors will lose out. For example, a comprehensive review of research over four decades by the UK's Centre for Sustainable Investment[33] concluded:

> *"The evidence reviewed here suggests that the use of SEE screens does not impact negatively on share performance. At best, the evidence appears to be moving towards a "SEE effect" that contributes to portfolio outperformance. At worst, this suggests that an investment policy using SEE screens is unlikely to harm financial returns."*

City research has come to similar conclusions. After examining many studies, Larry Chen of UBS said:

> *"We find no evidence that socially responsible investing confers any sustainable performance advantage in the long run.... Having said that, however, we do not believe that investing responsibly necessarily entails financial sacrifices."*[34]

More recently:

- Morgan Stanley worked with the German research firm Oekom, comparing the performance of the 602 companies in the MSCI World Index. Based on Oekom's ratings, 186 were judged to be sustainability leaders in their respective sectors. Their performance in 2000-2003 was compared to the rest of the MSCI constituents and they were found to have outperformed by 23 percent.
- AMP Henderson compared the performance of 14 SRI mutual funds in Australia with the performance of the S&P/ASX 200 index. The SRI median was worse than the main index in 2002, but better over three and five-year periods, through September 30, 2003. Over the three-year period, the SRI median outperformed the ASX 200 by 0.7 percent; over the five-year period, the SRI median returned 10.1 percent while the ASX 200 returned 8.0 percent.

Academics based at Maastricht University suggest that ethical funds undergo a "learning process" which sees them under-perform in the early years, then catch up. Using a complex model to analyse more than 100 funds in the US, UK and Germany, they found that UK funds had performed best. The statistical results are summarised in Table 4. For both domestic and international funds they show higher returns and lower volatility than conventional unit trusts, resulting in significantly higher Sharpe ratios[35].

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33 In Sustainability Pays, published by CIS, 2002
34 The Merits of Socially Responsible Investing, UBS 2001
35 The Sharpe ratio combines return and volatility to measure risk-adjusted returns. The higher the number, the better the performance

TABLE 4: SUMMARY RESULTS OF MAASTRICHT STUDY

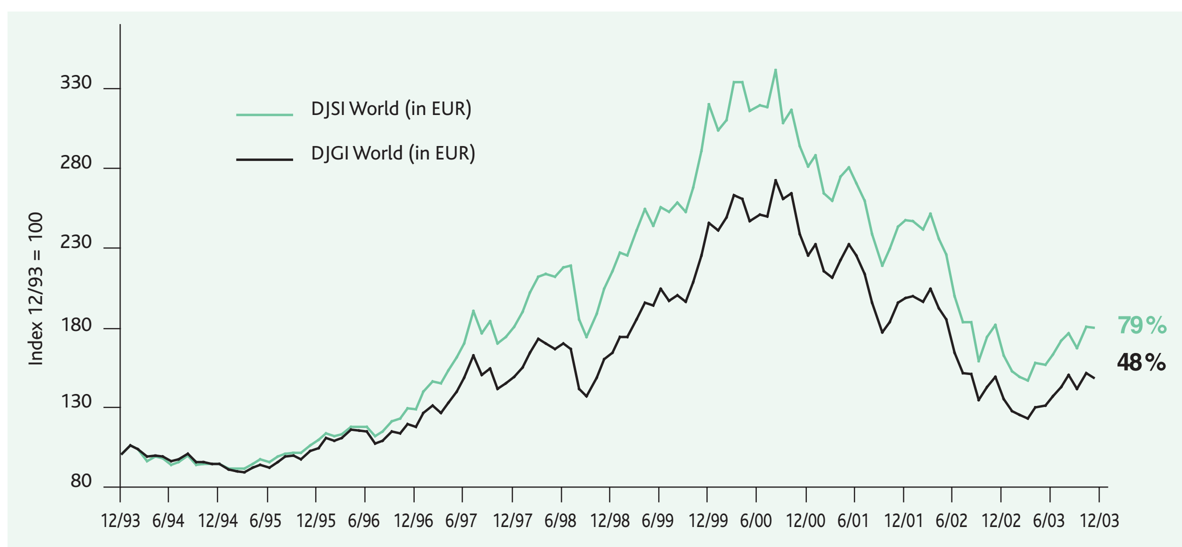
	Return %	Standard deviation	Sharpe ratio[37]
Domestic funds			
Ethical	9.81	13.11	0.16
Conventional	9.58	13.64	0.14
FT All-Share	10.95	14.22	0.22
International funds			
Ethical	8.92	15.16	0.08
Conventional	8.18	14.74	0.03
MSCI World	8.52	15.99	0.05

They considered that some of this outperformance could be due to investment style and to the benchmarks chosen. But after allowing for these factors they found that ethical and conventional funds performed similarly – ethical funds did not show higher risks or lower returns, as they concluded:

> *"Even after controlling for investment style we find no significant differences in risk-adjusted returns between ethical and conventional funds."* [36]

Other research has been more positive. For example, a team at WestLB found that "sustainability investing" could yield higher risk-adjusted returns (an 'alpha' return of 2.1% p.a after adjusting for market, style and size factors) and that this approach could fit many investment styles. The study examined the performance (between 1999 and 2002) of the Dow Jones Sustainability Index European components compared to the DJ Stoxx members – the universe from which the sustainability components are drawn. The DJSI has now sold nearly 50 licences for funds which have more than €2 billion assets under management. The chart shows that the global sustainability index has outperformed the Dow Jones global index since 1994, when data is first available.

FIGURE 1: PERFORMANCE OF THE DOW JONES SUSTAINABILITY INDEX



Source: SAM Indexes

[36] International Evidence on Ethical Mutual Fund Performance and Investment Style. Bauer, Koedijk and Otten 2002

[37] The Sharpe Ratio combines measures of risk and return the higher the number, the better the performance

WestLB analysed the components of outperformance and found that the performance of the sustainability stocks was not explained by sector or style bias, but there was an additional SRI return:

> *"sustainability filters can create added value regardless of whether one is a value investor, a growth investor, or an investor opting for the small, mid, or large-cap style."*[38]

Those results may, however, be influenced by the choice of the DJSI, which consists of companies who are leaders in a very broad definition of sustainability, including financial prospects. Once again, a more recent study[39] has challenged these findings, but also came up with an important message for investors – that it is crucial to look at what companies actually do, not just what they say. Unfortunately, in the absence of clear performance data, many decisions about corporate responsibility are taken on the basis of company policies and management systems, but the study by Pictet cast serious doubt on this approach.

The study was based on the share price performance between January 1999 and July 2003 of almost 300 European companies taken from the MSCI Europe index. It came up with many results which are not only contrary to the preponderance of previous research, but also sometimes counter-intuitive (eg social performance turned out to be more significant than environmental, while good corporate governance seemed to be a negative factor for share price performance).

But the overall findings are that the best results come from concentrating on what matters most and by combining that with financial criteria – precisely the approach which mainstream SRI is now taking. As the authors of the Pictet study wrote:

> *"Factors more closely related to the actual sustainable performance "in the field" (both along the environmental and the social value chain) consistently showed a more positive contribution toward the stock price performance than formal criteria. To put it more clearly, one could say that the only thing that seems to matter is what a company does, not what it says."*

Indeed, this picks up a theme from research based on the environmental assessments used by the rating firm Innovest (see section 5). Unlike most SRI approaches, Innovest focuses on the potential impacts on shareholder value of companies' environmental performance. The research[40] compared the share performance of a portfolio selected on this basis with the S&P500 between 1997 and 2000. The results were stark – the Innovest portfolio produced a total return of 3.4% in this period, which straddled the dotcom boom and bust, when the S&P500 fell by 9.1% and many traditional SRI funds also suffered.

Innovest has also carried out a "live simulation" to test the impact of its criteria on six real US portfolios (representing different investment styles) in real time. Shadow portfolios were created at the beginning of 2001, and tracked through the year against the actual portfolios. Three shadow portfolios were created for each, based on different levels of tracking error, or deviation from the basic portfolio. In five out of the six cases, the Innovest-adjusted portfolio outperformed the real investments – and the difference was greatest in those where the Innovest adjustment was strongest (i.e. where the greatest tracking error was allowed) as the chart shows.

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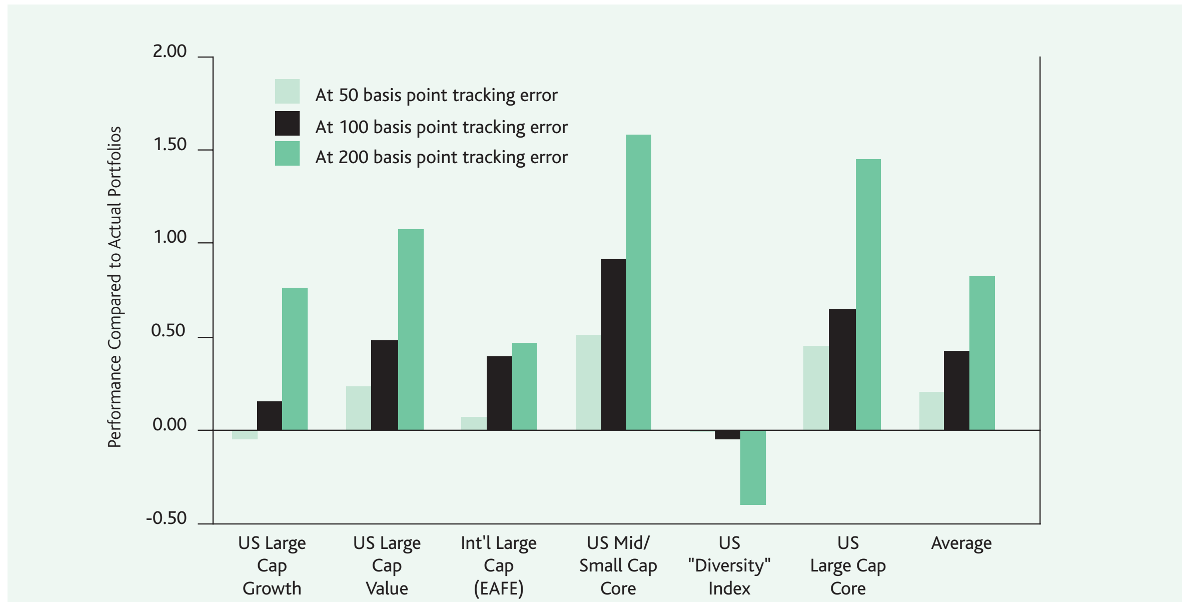
38 More Gain Than Pain, Garz, Volk and Gilles, WestLB Panmure 2002
39 Decomposing SRI Performance, Pictet 2003
40 The Eco-efficiency Anomaly, Blank and Carty, QED International Assoc 2001

FIGURE 2: RESULTS OF INNOVEST REAL-TIME SIMULATION



Source: Innovest

Innovest has also carried out many sector studies which show better performance from more responsible companies, e.g. in the food sector the companies which received the highest scores from Innovest (led by Cadbury Schweppes, Unilever and Danone) outperformed the rest by 33% from 2000-2003[41].

Bonds and credit ratings

Research has concentrated on equities, but corporate responsibility could be expected to have similar impacts on bonds, and more broadly on credit ratings. Indeed, since company-specific risk is more significant for bonds than for equities, it might be expected that bond prices are more sensitive to the downside risk which is typically the most easily understood and recognised element of any SEE effect (the threat of harm from an environmental crisis or social calamity is generally more tangible than the promise of benefit from high levels of corporate responsibility).

One recent study[42] has found that companies with greater social responsibility do also have higher credit ratings. The study compared Moody's bond ratings for companies included in the FTSE4Good index and equivalent companies excluded from the index. After adjusting for geographical and sector biases, the socially responsible (SR) group were found to have consistently higher credit ratings over the past five years. Just over half the SR group were rated AAA-AA3 in 2003, compared to just over a fifth of the other group. Examination of upgrades and downgrades supported this story, and the advantage for social responsibility companies was also evident in average spreads.

An interesting light is shed on the broad conclusions from these findings – that investors will do better if they take account of social and environmental, as well as financial, factors – by the startling results of an experiment carried out by PricewaterhouseCoopers (PwC) with Schroders. Two teams of Schroders' analysts were asked to make recommendations and forecasts based on the annual report of Coloplast, the Danish healthcare company (although they were not told which company it was). One team was given the

[41] SocialFunds.com 9 July 2003

[42] Applying Socially Responsible Investment Criteria to Corporate Bonds, Miranda Carr, unpublished MSC thesis, Cass Business School 2003

full report, including comprehensive social and environmental data, while the other group's report included only general non-financial narrative. Two-thirds of the team with the fuller information made buy recommendations, while three-quarters of the group with little social and environmental data recommended selling. The first team were also more confident about their recommendations, and the range of their earnings estimates was much tighter than the financially-oriented group. There is as yet no evidence to show which group would have made the higher returns, but the exercise reinforces what many analysts know – that financial analysis alone is not enough to understand a company.

CSR and shareholder value

Risk and responsibility

A plethora of studies over the past decade, several of which are referred to later in this section, have demonstrated the links between greater corporate responsibility and financial returns. Risk has often been left out of the equation, but risks from issues such as climate change, new technology (e.g. GM crops) and social friction often provide the clearest and most understandable link to shareholder value.

Reputational risk, in particular, has become more significant for companies. Research by the insurer Aon among leading UK organisations found that loss of reputation was seen as the greatest risk, up from fourth place in 1999[43]. Commenting on the contrast between rising expectations and deep distrust of business, one expert commented recently:

> *"This gap presents a fertile opportunity to enhance corporate reputation by being reliable, trustworthy, accountable and transparent, and demonstrating this not just by fine words but through positive action".*[44]

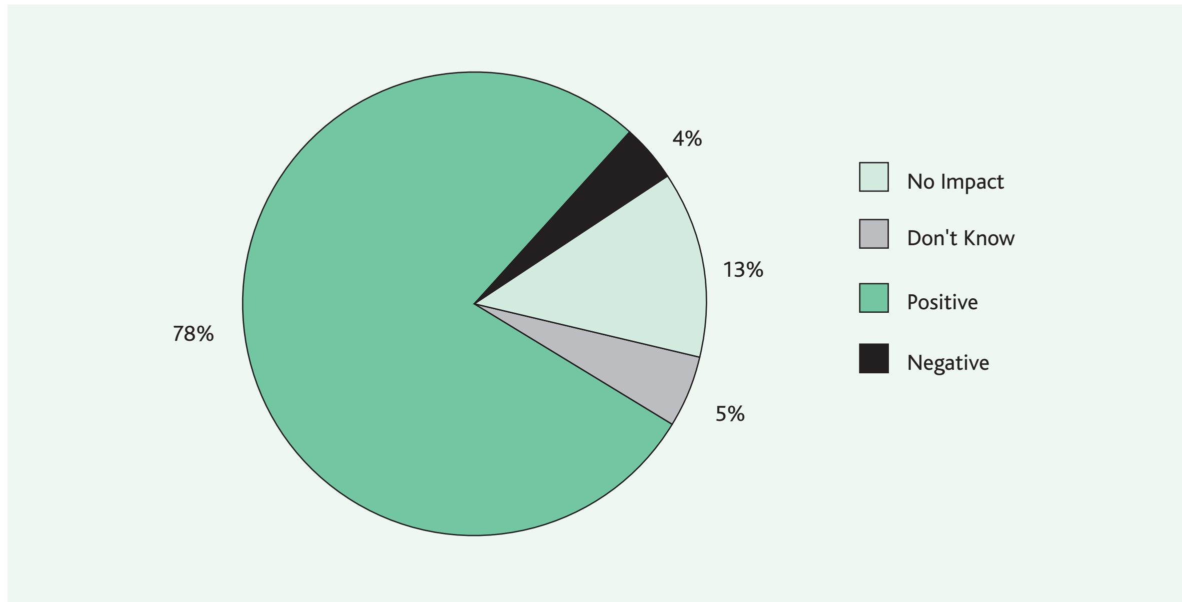
Companies are gradually understanding more about the risk aspects of corporate responsibility, encouraged by the spread of risk management systems to embrace strategic, social and environmental risks, as well as formal requirements such as the Turnbull Committee's recommendations in the context of corporate governance. The new Operating and Financial Review (covered in section 2) will strengthen the formal requirements to report on the management of social and environmental risks.

Importantly for investors, companies seem to be coming to terms with new kinds of risk at very different speeds. A review[45] of formal SEC disclosures by US companies in critical sectors for climate change (e.g. utilities, autos, petrochemicals) found a wide range of responses. In every sector, at least one company reported significant risks from climate change, but many companies in the same sectors did not. Overall, almost 40% of companies forecast that climate risks will have an adverse impact, while 15% said that global warming poses little to no risks. About 27% state that the impact of climate change cannot be estimated, while 18% avoided addressing the issue of financial risk altogether. This suggests that investors in non-reporting companies (e.g. all the auto companies except Ford) should be concerned about their management of these risks.

Investors certainly seem to want companies to manage social and environmental risks better. Research among fund managers and analysts across Europe found a substantial majority who believe this will have an impact on shareholder value in the long-term, as Figure 3 shows (there was less confidence in short-term benefits).

[43] Aon Biennial Risk Management and Risk Financing Survey 2001
[44] Managing Reputational Risk, Jenny Rayner, Institute of Internal Auditors 2003
[45] Second Survey of Climate Change Disclosure in SEC Filings, Friends of the Earth 2003

FIGURE 3: VALUE OF SOCIAL AND ENVIRONMENTAL RISK MANAGEMENT



Source: Investing in Responsible Business, CSR Europe, Deloitte, Euronext

Different kinds of risks need to be considered. They range from the sudden crisis, typified by Shell's experience with the disposal of the Brent Spar oil platform, to a shift in attitudes which makes an accepted business practice unacceptable, e.g. animal welfare, developing country labour standards, social exclusion. A Brent Spar-style crisis is, by definition, rare but can have an enormous and wide-ranging impact. It is particularly relevant to certain exposed sectors, especially extractive industries. Other risks are more pervasive, accumulative, and may have less dramatic – but no less significant – impacts on sales, costs, employee morale, customer loyalty, or other important business drivers.

The nature of SEE risks means they are often intangible, unpredictable and much more difficult to quantify than conventional operational risks. They are linked to globalisation and technological development, but also demographic and wider social or cultural changes such as the decline of trust reported in section 2, e.g. the reaction to genetically modified foods and other aspects of biotechnology. In some cases there may be a direct threat to revenues and costs (e.g. Monsanto and the GM controversy) but often the threat will be more subtle, e.g. reputation damage which eventually leads to loss of business or other tangible financial impacts.

The wide-ranging, inter-connected nature of these risks means it is now seen as important for companies to take a strategic approach. For example, the World Business Council for Sustainable Development (WBCSD) has urged chief executives to adopt a comprehensive approach[46]. The group of risk experts from leading companies such as EDF, Allianz, Swiss RE, Shell and Ford says the nature of corporate risk has changed and expanded to include:

- brand and reputation protection
- asset vulnerability due to greater emphasis on intangibles
- changing markets
- political, social and economic instability
- terrorism and sabotage
- human capital
- vulnerability of infrastructure
- IT and communication risks

[46] Running the Risk: Risk and Sustainable Development, WBCSD Discussion Paper (draft) 2003

- the development and application of new technology, including its acceptability to the market and society in general

The WBCSD group argues that these new "systemic" risks cannot be dealt with solely by the "risk owner" but need a systemic response, That means, especially, collaborating with other companies and other organisations such as NGOs, which the group describes as "probably the biggest shift in thinking required by corporate organisations".

Research into severe share price movements supports the view that strategic risks are critical – both on the upside and the downside. One study[47] examined the 100 most severe price shifts over a five-year period to 2001 for the world's 1,000 largest companies. It found, first, that such severe share price events were quite common – there was a 40 per cent chance of a firm losing more than 30 per cent of its value (compared to the market) in a five-year period. And on the whole that underperformance continued for at least a year, because most of these major value shifts (72%) were strategic in nature rather than financial or operational. Typically, sharp share price falls stemmed from a failure to anticipate rapid market changes.

Some risks are clearer than others, notably environmental issues, which represent risks in situations such as takeovers as well as directly to an operating company. Risks such as climate change have now been widely studied. The Environment Agency and the government-backed UK Climate Impact Programme has published guidance and provides training on assessing climate change risk[48]. As noted in section 3, some analysts have begun to examine the potential impacts of climate change on exposed sectors such as aviation and power generation. The financial risks from a rise in the cost of carbon emissions are beginning to be quantified, e.g. it has been estimated that if companies had to pay £35[49] for every tonne of carbon they were responsible for, the total cost to FTSE100 companies would be just over £33 billion – roughly one and a quarter times earnings. The leisure industry would be hit quite hard - its costs would rise by about an eighth of turnover, while the supermarkets would see three-quarter of earnings disappear with extra costs amounting to 2.4% of sales.[50]

Despite the significance of sustainability risks, evidence suggests that many companies are not yet managing these risks appropriately. PricewaterhouseCoopers found that even among those (US) companies that were addressing sustainability because of fears about reputation risk, only a third are formally evaluating sustainability risks and opportunities[51]. This was true across most industries, alarmingly including financial services and energy, and even among many companies which said sustainability was a very important business driver, as the chart (next page) shows.

Companies were asked to score how important sustainability was to them, on a scale of 1 to 10. The chart shows that even among those which gave a top score of 10, a fifth were not properly evaluating sustainability risks. That proportion was much higher for companies giving a score less than 10, even though sustainability was still very important to them. Some companies were evaluating sustainability risks, but the majority were not. This kind of disparity is important for investors, who need to know how well a company is managing all its risks if they are to make rounded investment judgements.

[47] Managing the Risks Behind Sudden Shifts in Value, Rory Knight and Deborah Pretty, European Business Forum Winter 2002/3

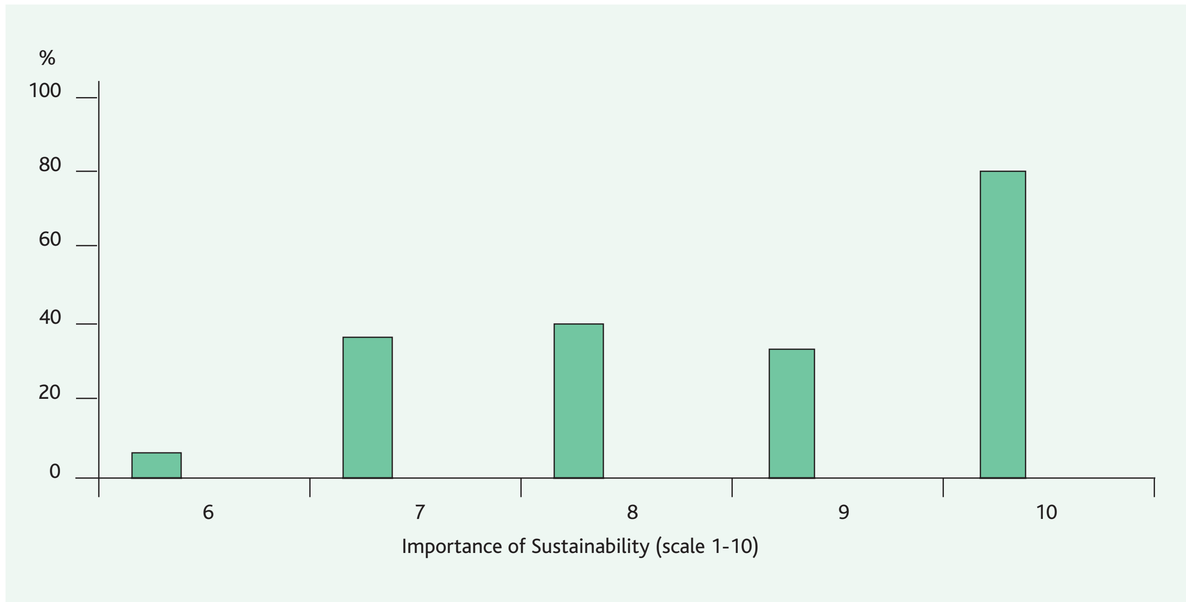
[48] Climate Adaptation: Risk, Uncertainty and Decision-making, UKCIP 2003

[49] This is the lower limit of the government's estimate of the "externalities" of carbon dioxide emissions

[50] Based on a model developed by Trucost

[51] 2002 Sustainability Survey Report, PricewaterhouseCoopers

FIGURE 4: THE PERCENTAGE OF COMPANIES EVALUATING SUSTAINABILITY RISK

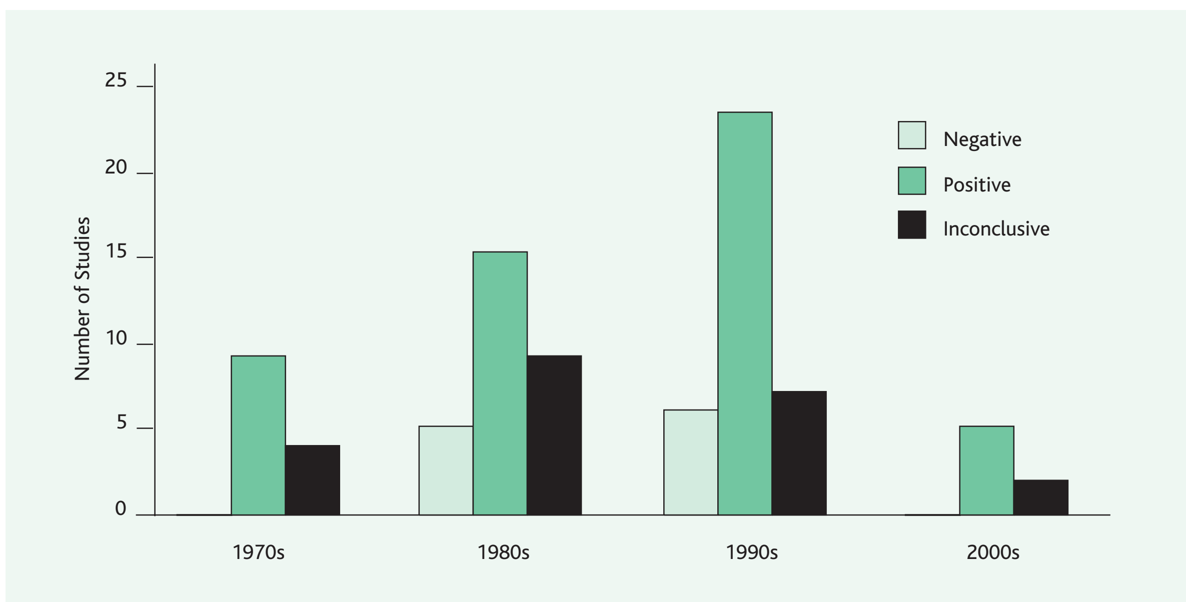


Source: PwC

The bottom line

Many studies have established links between corporate responsibility and various aspects of business success. They easily outnumber studies finding no link or a negative correlation, as the chart shows.

FIGURE 5: CORRELATIONS IN RESEARCH STUDIES



Source: Sustainability Pays, Forum for the Future/CIS

Some of this research has been concerned with overall performance, e.g.

- Orlitzky examined event studies (impacts of polluting spills or other damaging major events) and found a positive correlation between corporate responsibility and financial performance[52]
- Graves and Waddock[53] analysed a number of 'visionary' companies identified in the book, Built to Last by Collins and Porras. Graves and Waddock examined the extent to which these visionary companies achieved their extraordinary performance by good stakeholder relationships. They concluded that there is a positive relationship between the overall quality of management of a firm and the way it treats its critical stakeholders
- the overall financial performance of Business Ethics magazine's 'Best Citizen' companies was found to be ten percentile points higher than the mean performance of the remainder of the S&P 500 constituents[54]

This kind of research has been criticised on two counts. First, it does not establish a causal relationship (it is possible that more successful companies have more scope to invest in corporate responsibility, rather than success flowing from that investment). And second, the research does not necessarily control for all variables – e.g. a review of the Graves and Waddock work found that the performance differences could be explained by conventional business issues such as research and development spending or advertising. Nevertheless, while the positive link may be "not proven", the weight of evidence is certainly in that direction and there is little support for the negative.

Other work has focused on specific factors, such as reputation. To some extent, reputational benefits are involved in other areas such as employee and customer loyalty. But there are also potential reputational benefits in brand value and the concept of "licence to operate". While that term is often used as a metaphor it can be tangible, especially in the case of companies competing for public service contracts, where the government authority or agency awarding a contract in one field (e.g. schools or hospitals) may be influenced by the bidder's reputation in another (e.g. rail), or where one country's government (e.g. awarding telecoms licences) may take account of bidders' reputation in other countries.

It is certainly true, as discussed in section 2, that trust in the business world in general has fallen in recent years, and polls show that the public claims to be impressed by corporate responsibility[55]. The drawback with such polls is that those opinions and attitudes only partly translate into action at the checkout or in looking for jobs - two areas where there is substantial attitudinal evidence.

Consumers - polls have consistently found significant numbers of shoppers who claim to boycott products from irresponsible companies, and to factor ethical issues into their purchasing decisions. There is clearly substantial over-claiming, given the small market share of groceries, for example, taken by ethical products. But, importantly, the proportion of shoppers saying this is important has grown steadily – from 28% to 44% between 1998 and 2002[56]. The size of the ethical market has also grown rapidly – by 13% in 2002 for a basket of products and services, which now account for more than £7bn sales, with a further £7bn in ethical banking and investments[57]. There is clearly significant potential for further growth, given continued publicity to the kind of issues which concern shoppers, and better information on product sourcing and conditions. There is a large segment of the market which is concerned with social and environmental issues but not active ethical shoppers, which represents a latent pool that can be activated by particular incidents (e.g. food safety crises, child labour exposés)[58].

52 Corporate Social Performance: Developing Effective Strategies, Centre for Corporate Change 2000
53 Beyond Built to Last, Boston College School of Management 1999
54 Verschoor and Murphy, Strategic Finance January 2002
55 See, for example MORI annual CSR study, Environics Global CSR Monitor
56 MORI annual CSR polls
57 The Ethical Consumerism Report 2003, Co-operative Bank
58 See Who are the Ethical Consumers? Cowe and Williams, Co-operative Bank 2000

From the investors' point of view it is important to see that consumer concern and pressure is not uniform, nor is it stable. Certain issues are particularly prominent, e.g. child labour and developing world agriculture. But others can suddenly spike without warning, e.g. obesity. Investors need to know how thoroughly companies have assessed the risks from such concerns, and how well they are managing them.

Employees – studies have found clear links between "responsible" employment policies and business performance. One piece of research found as many as 96% of companies which had implemented policies on work/life balance said their business had benefited[59]. A substantial majority also reported benefits from policies on equal opportunities, diversity and action on climate change. Other research points to the links between responsible employment practices and a high-performance workforce, especially in the growing number of "knowledge" businesses and the need for businesses to push initiative down through the workforce[60].

Responsible employment practices can also help recruitment, retention and motivation. For example, companies which can demonstrate greater responsibility will find it easier to attract the best recruits[61]. Employees have also reported improved perceptions of companies which engage in community involvement[62]. This follows from attitude surveys which find strong preferences (and stronger than in the past) for responsible employers, especially among the best graduates[63]. Research among employees by Business in the Community[64] found that almost half said it was very important for their employer to take social and environmental responsibilities seriously. That means putting promises into practice, which seems rare - 88% said it was important that employers "live their values" – but only 45% said their own employers do so.

Employees seem to be particularly affected by traditional corporate responsibility activity such as community involvement, especially for employees involved in volunteer work. For example, following a volunteering initiative at British Gas in Cardiff, the company found:

- the number saying the company was a good place to work increased from 57% to 63%
- job satisfaction among the volunteers rose from 62% to 67%
- the proportion of volunteers saying British Gas helped the local community rose from 45% to 65%
- two-thirds said volunteering made them feel more positive about the company

Specific impacts can be very important and can have a significant and direct financial impact. For example, tyre quality at the Bridgestone/Firestone plant involved in the Ford tyre recall crisis was found to have suffered because of bad industrial relations[65].

As with consumers, however, the impact of corporate responsibility on employee behaviour is not uniform across the economy or through time. But, also as with consumers, it does appear to be growing. It is, therefore, important for investors to understand the critical issues for the companies they are invested in, and how well those companies are managing them.

Environmental aspects of responsibility generally provide the clearest links with financial returns. At its simplest, saving energy and cutting waste saves money (and although it may require investment, paybacks are typically very swift). Similarly, avoiding pollution incidents avoids hefty fines as well as reputational damage. More strategically, companies may benefit from developing products which meet emerging consumer demands, e.g. for recycled content or recyclability and lower energy requirements.

Academic work has found a correlation between strong environmental performance, especially in pollution prevention, and financial returns[66]. The benefits will vary from sector to sector, of course, and

59 A New Business Agenda for Government, Ella Joseph, IPPR 2003
60 e.g. The Missing Link, from Productivity to Performance, Work Foundation 2003, and Responsibility, Driving Innovation, Inspiring Employees, Business in the Community FastForward Research 2003
61 Corporate Social Performance as a Competitive Advantage in Attracting a Quality Workforce, Greening and Turban, Business and Society 2000
62 Good Companies, Better Employees, Corporate Citizenship Company 2003
63 MORI 2001
64 Responsibility: Driving Innovation, Inspiring Employees, BitC with Bupa and CIPD 2003
65 Strikes, Scabs and Tread Separation, Krueger and Mas, NBER Working Paper 9524
66 Strategic Environmental Management, Where Does it Create Value? Berchicci and Hockerts, INSEAD Working Paper 2001; and Exploring the Locus of Profitable Pollution Reduction, King and Lennox, Management Science 2001

depending on local anti-pollution measures. For example, reducing waste will be more cost-effective where the costs of landfill are rising, as in the UK, and will obviously be more important in sectors where landfill costs are more significant.

Materiality

Increasingly, research has moved from looking for generic CSR impacts to a recognition that impacts will vary widely over time, place and sector. The aim, then, is to understand what is (or is likely to be) material for industrial sectors and individual companies (something that will be required by the new OFR). A research project which sought to learn from a group of companies with considerable CR experience concluded that they were groping towards a clearer understanding of its importance in their own companies, but their experiences did not add up to a general framework. The researchers argued that companies need to:

> *"build a consensus within their company behind a vision of what they wish to be responsible for, to whom, and how they wish to measure and report on their performance against the vision. That process will force companies to consider their unique competences and determine how they can be leveraged to different social and economic ends."*[67]

They argued that this rigorous assessment and measurement represents "the true business case for CSR", i.e. driving a deeper, longer-term understanding of business performance and strengthening integration within the company as well as between it and its stakeholders.

Interestingly, this kind of specific and detailed understanding of CSR is precisely what is emerging from leading companies. For example, the construction and services company Carillion has recognised the links between its business objectives (e.g. earnings growth, market-leading positions) and sustainability objectives (e.g. community development and environmental protection) and identified 13 key performance indicators (KPIs) which link the two sides of this equation.

For example, employment indicators such as workforce diversity, absenteeism and the accident rate link to business objectives for a highly effective workforce, and to social objectives for healthy communities. Similarly, sustainability targets and suppliers who meet high environmental standards relate to business objectives for improved reputation and reduced risk, as well as social objectives for protection of the environment.

Quantification is also developing. BT has used its customer research to identify the CSR component of customer satisfaction. It found that reputation and image were the second most significant determinant of customer satisfaction after contact with the company when reporting faults etc, and over a quarter of the overall figure for image and reputation was attributable to CSR-related activities (when commentating on CSR, BT's customers prioritised maintenance of unprofitable payphones in remote areas, the treatment of employees and the environment). The link can be quantified: if customers' perceptions of BT's corporate responsibility changes by 1%, its customer satisfaction rating would change by 0.13% per cent. And since customer satisfaction is important in retaining customers (a key driver for BT) a direct financial connection is established.

The Co-operative Bank has gone further, calculating both the costs and benefits of its ethical policy, and concluding that its stance is responsible for roughly a fifth of profits.

As companies get more skilled at understanding and quantifying the business impacts of social and environmental issues, it will be easier for analysts and investors to incorporate such issues into decision-making. It will also become more important, as greater clarity is likely to lead to more significant share price impacts.

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[67] CSR at the Crossroads, Maklan and Knox, Cranfield School of Management 2003

ANALYSING CORPORATE RESPONSIBILITY

Research capability in this field has developed along with the deepening understanding of the issues and how they affect shareholder value. The early research effort was associated with the rise of ethical retail funds at firms such as Jupiter and NPI (now Henderson) and the concerns of groups such as churches and charities. The emphasis was on identifying companies which were involved in specific activities to be avoided (typically tobacco, arms, gambling and the nuclear industry) or to be targeted (such as health care, environmental improvements). This work built comprehensive knowledge of sector and company activity, in specialist research teams and independent providers such as EIRIS, which now provides information to many users, including the FTSE4Good indices.

With the rise of SRI, investor needs grew more sophisticated and researchers have moved beyond a yes/no approach to corporate activity, focusing on the impacts of what companies do on shareholder value as well as on the environment and society. While the area remains essentially subjective – as with much company analysis – techniques have emerged to bring rigour to analysts' judgements.

Several specialist firms have developed proprietary approaches, typically based on combining assessments of risks facing companies and their performance in dealing with those risks. For example, SERM has developed a methodology for rating companies' reputation risk. Advised by a panel of distinguished experts, it has established risk levels for industry sectors and geographic regions, which form the basis for the firm's assessments. These underlying risk levels are mitigated by risk reduction factors, which analysts arrive at based on a comprehensive analysis of hundreds of information sources around the world. The resulting rating provides an analysis of key exposures and comparisons with other companies in the sector.

In the rest of this section we report the approaches of two other firms which have developed rating methodologies along similar lines. CoreRatings is a sister company to the Fitch credit rating agency, formed through the merger of the UK's Global Risk Management Services and the French research company ARESE. It is based in London. Innovest began analysing corporate environmental exposure in the US and subsequently developed to cover social issues and to operate beyond the US. It is based in New York, London and Toronto, and is now part-owned by the Dutch pension fund ABP.

Their approaches differ, and as with all analysts' work, may come up with different conclusions. Similarly, as with financial analysis, investors and financial advisers. may have different assumptions about the importance of key factors in the analysis, and, therefore, come to different investment conclusions. But importantly, both firms aim to provide a service to business, investors and advisers. They do not make moral judgements, but are concerned with potential impacts (positive and negative) on shareholder value.

CoreRatings and the financial sector

CoreRatings assesses the extent to which corporate responsibility risks (such as social and environmental issues) threaten shareholder value. Their approach is to identify which issues are relevant for investors in a sector, then assess how well each company in the sector is managing the associated risks. The outcome is a rating currently on a scale from A to D (it will be expanded in 2004 to highlight differences in performance more clearly). The rating aims to answer the question: "to what extent is the company controlling and managing its material business risks in a way that maximises value to shareholders and addresses reasonable stakeholder concerns?"

Step 1 – identifying sector exposure
The assessment covers four broad areas of potential impact – environmental, social, employment and ethical. For each sector analysts consider a long list of sector specific potential risks in these four categories, grouped under 14 sub-headings (such as working conditions and use of natural resources).

Analysts identify the significance of each issue for the sector they are studying. For example, banks have minimal direct exposure to child labour, but that is clearly a major issue for buyers of clothing and other products made in certain developing countries. On the other hand, money laundering is a significant risk which has become a high profile issue for banks, especially because of concerns over funding for international terrorism.

Even within broad sectors, impacts can vary widely. For example, environmental risks have significant financial implications for property and casualty insurers, through payouts relating to natural disasters and extreme weather, and retrospective liabilities for claims such as asbestos. These issues are not directly relevant to retail banks, however.

Step 2 – weighting investment effects

Weightings for each issue are based on an assessment of the extent to which it might affect shareholder value. Some issues may be extremely important to campaign groups and individuals, but may be unlikely to have significant financial consequences for businesses in the sector. Many banks have implemented detailed management systems covering issues such as paper and energy consumption, for example, but the environmental and human rights issues associated with project finance, plus the regulatory pressure and reputational damage from business ethics issues (such as analyst independence), have far greater potential to affect companies' operations and financial strength.

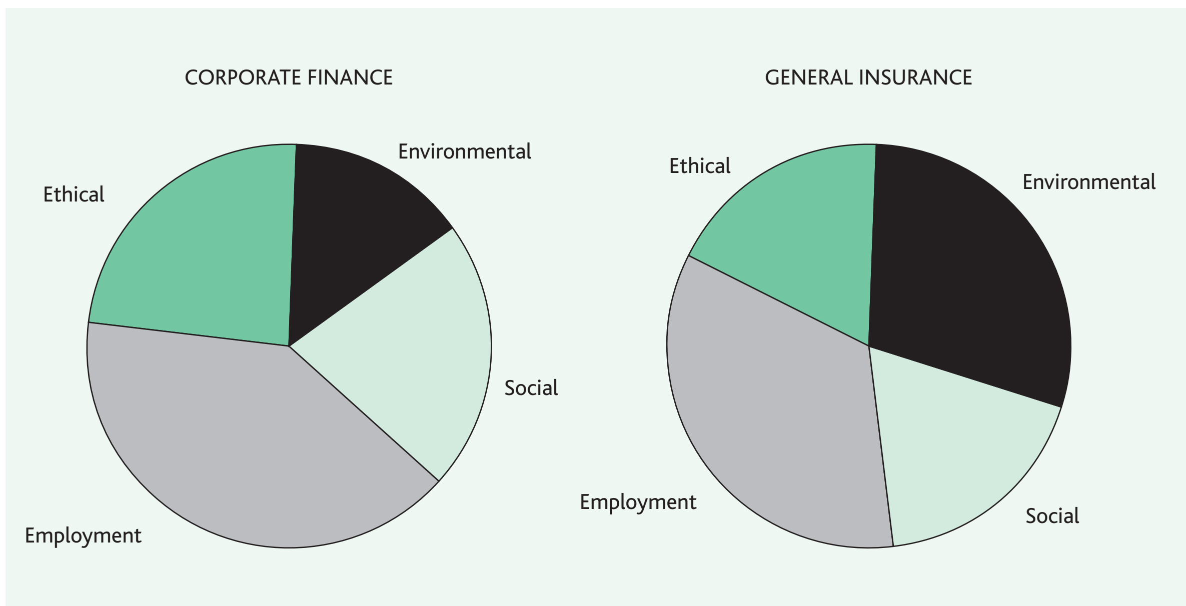
The potential effect on shareholder value is gauged against seven investment value drivers, which together capture how CR risks can have a financial impact on companies. Most are concerned with negative impacts of risks, but the inclusion of "competitive advantage" allows analysts to factor in potential benefits to companies from addressing responsibilities better than their rivals. Mapping issues against these value drivers acts as a 'reality check' in ensuring that those factors which are likely to have a significant impact on shareholder value carry the most weight in the rating process.

TABLE 5: CORERATINGS' INVESTMENT VALUE DRIVERS

Brand value	The value of individual product brands
Intangible value	Long-term corporate value, including goodwill and intellectual property
Collateral damage to reputation	Effect of the company's activities on the reputation of its key suppliers, customers and financial backers
Regulatory interference	Impacts on costs and/or revenues of tighter scrutiny
Legal liability	Exposure to individual and class actions
Access to people skills	Ability to attract and retain workers at competitive rates
Competitive advantage	Ability to continue delivering competitive products or services

The diagram below shows the weightings given to the four areas of risk for the corporate finance and general insurance sectors, and the table shows the components of risk analysed by CoreRatings. As mentioned earlier, the charts show environmental risks to be more material to general insurance companies, whereas business ethics risks are of more significance for corporate finance activities.

FIGURE 6: CORERATINGS' WEIGHTINGS OF THE FOUR RISK AREAS



Source: CoreRatings'

Stage 3 – rating individual companies

The final stage of the rating process gauges how well an individual company is managing its material risks. Management performance is assessed in five areas:

- Policy development – how well-developed are policies in the risk areas identified in the sector analysis?
- Policy implementation – are there specific targets and other mechanisms for implementing policies throughout the company?
- Policy compliance/Assurance – are there robust reporting and other compliance mechanisms?
- Performance – what is the record?
- Transparency and disclosure – how well does the company engage with stakeholders and disclose policies and performance?

Analysts assess performance based on information from thousands of news sources around the world, company and other public information, plus interviews with company management. The overall rating awarded to a company (A to D) is a mathematical derivation of the weighting of a company's key investment risks and how well the analysts consider the company is managing them. For example, an overall score of 65% equates to a 'B' rating.

BOX 4: CORERATINGS' SCORING SYSTEM

CoreRatings' has rated about 100 publicly quoted banks, insurers and other financial companies. The majority have received ratings of B or C, with just a few managing corporate responsibility risks well enough or badly enough to merit an A or D.

Companies' risk management strategies affect ratings in various ways, depending on the sector. For example, ratings of property and casualty insurers in many countries often reflect the fact that they are not able to disclose mechanisms for incorporating climate change and environmental issues into the pricing of coverage, despite Hurricane Andrew threatening the solvency of several US companies back in 1992. Similarly, insurers are some of the world's largest asset managers but often do not consider the significant effects that environmental and social factors can have on the value of those assets. In project finance and commercial lending, there is wide variation in the sophistication of lenders' methods for assessing the environmental and social risks which may affect a borrower's repayment ability. The London listing of Xstrata (which has heavy exposure to coal and, therefore, climate change activity) in 2002 also demonstrated the need to consider these issues in the prospectuses for new equity issues, while the recent focus on corporate ethics (especially in the US) highlighted the need for effective codes of conduct, implementation and compliance mechanisms. Again, the extent to which companies are able to demonstrate that these risk management systems are in place often shows considerable room for improvement.

Innovest on the computer industry

Methodology

Innovest has developed a rating approach which aims to capture for investors the extent to which companies' strategies address social and environmental issues, and their ability to deal with non-traditional risks. Ratings are derived through two models, one focussing on environmental issues (EcoValue'21®) and the other concerned with social issues such as human resources management and emerging markets strategies (Intangible Value Assessment or IVATM). Both models combine an assessment of risks and opportunities facing a company with its ability to manage these, and reflect how each company stands in relation to others in its sector.

The models use quantitative data covering performance and risk (such as emissions, fines, injury rates, employee and customer turnover) combined with analysts' qualitative judgements of the likely financial impacts - either quantifiable in the accounts or linked to intangible value drivers such as reputation and management quality.

Judgements are based on factors such as board-level governance, staff and training commitments, integration of sustainability into pay and bonus systems, stakeholder relations, and the extent of sustainability innovation. The emphasis is on understanding how well companies will be able to respond profitably to emerging risks and trends linked to the principles of sustainability. Information is gathered from company, industry and third-party sources, supplemented by interviews with senior company management in key functions such as environment and human resources, directors, and in many cases company CEOs.

The ratings, which range from AAA to CCC, are concerned with strategic positioning and quality of management, which Innovest believes determine how well risks are managed and highlight companies with competitive advantage. They do not reflect absolute levels of risk, but a combination of exposure and the ability to manage that exposure. Ultimately, they aim to give investors an insight into the likely impacts on shareholder value in the medium-term of social and environmental factors, which are not typically included in conventional financial analysis.

EcoValue'21® is concerned with three types of environmental risk:

- historical liabilities, eg asbestos, contaminated sites, product liability
- current risks from continuing operations, eg emissions, waste, infrastructure risks
- emerging risks from poor sustainability positioning, eg product sustainability profile, phase-out risk

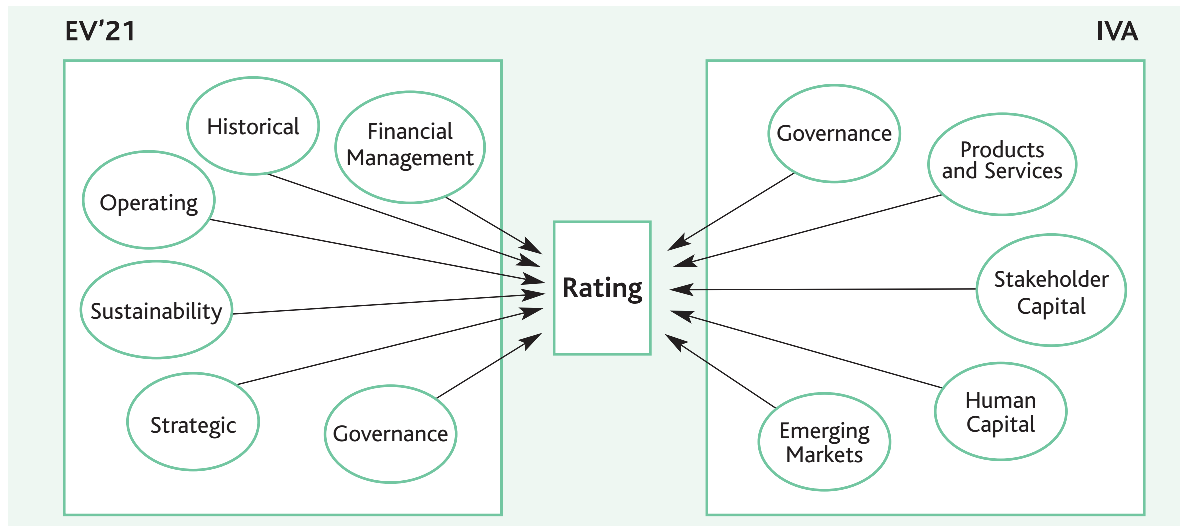
Analysts consider these risks in relation to the company's ability to manage them, including insurance and balance sheet strength, but also look for potential to profit from environmental developments in the market place. Research includes an assessment of environmental strategies, environmental management systems and eco-efficiency gains.

Intangible Value Assessment™ examines five areas of intangible value:

- governance – alignment with shareholder interests and with non-traditional risks
- human capital – management of recruitment, retention and motivation, training and development, labour relations, health and safety
- stakeholder capital – management of relationships with key stakeholder groups, including regulators and local communities
- products and services – intellectual capital relating to social and environmental issues, opportunity costs, product safety
- emerging markets – exposure to and management of issues such as human rights and working conditions

The contribution of these factors in the two models is depicted in figure 7.

FIGURE 7: INNOVEST'S RATING MODEL



For each of these broad issues, analysts examine many detailed attributes to build up an accurate picture of performance – more than 180 in total. For example, EV'21 research includes the integration of environmental policies throughout the company by looking into accountability and reporting structures, evidence of board commitment and whether bonuses are linked to meeting environmental targets. Factors such as the quality of key performance indicators (KPIs) and external verification also score points, as does the ability to address emerging opportunities for environmentally-related product innovation, and preparedness for legislation (e.g. the European Directive on Waste Electrical and Electronic Equipment (WEEE)). Similarly in IVA research, issues typically cover governance standards, benefits offered above usual requirements, employee turnover, health and safety improvement programs and performance, whether products fulfil a role in society such as combating disease or reducing a dependence on natural resources, giving rise to strategic social profit opportunities.

Scoring

Scoring is relative - for each attribute the most "progressive" company in the sector is assigned the top score, while the lowest score goes to the least progressive. Others are scored relative to these points. Total scores for each issue are calculated using weightings for each attribute which are intended to reflect relative importance for future shareholder value in the sector being analysed. In the computer industry, for example, issues around the "digital divide" and recycling will be higher than in other sectors where take-back legislation is less prominent. The weightings have been derived from back testing on Fortune 500 companies and through consultation with financial and sustainability specialists.

The computer industry

Innovest says the key issues for the computer industry are:
Environmental:

1. Producer responsibility/take-back legislation - the European Union's Waste Electrical and Electronic Equipment Directive, Japan's Appliance Recycling Law, laws in progress through 24 US state legislatures. Companies will incur direct and indirect costs which may or may not be able to be passed on to customers; those such as Hewlett-Packard with well-developed design recyclability will have an advantage.
2. Product design – design to minimise environmental impacts, including minimising the use of hazardous materials such as cadmium and mercury.
3. Operating risks – energy consumption, waste generation and emissions of greenhouse gases and pollutants.
4. Environmental business development – research and development to meet growing environmental demands of consumers.

Intangible value:

1. The digital divide – the imbalance of access to technology between rich and poor, which may provide market opportunities to companies which can cross the divide, as well as reputational benefits.
2. Emerging markets – will be major markets in the future, so companies with strategies to enhance their positions there and deal with issues such as labour conditions and human rights will have an advantage.
3. Health and safety – especially the chemical hazards in "clean rooms" which have already resulted in legal settlements by IBM.
4. Human capital development – essential to maintain suitably qualified and motivated staff.
5. Social business development – accessibility to equipment for disabled users.

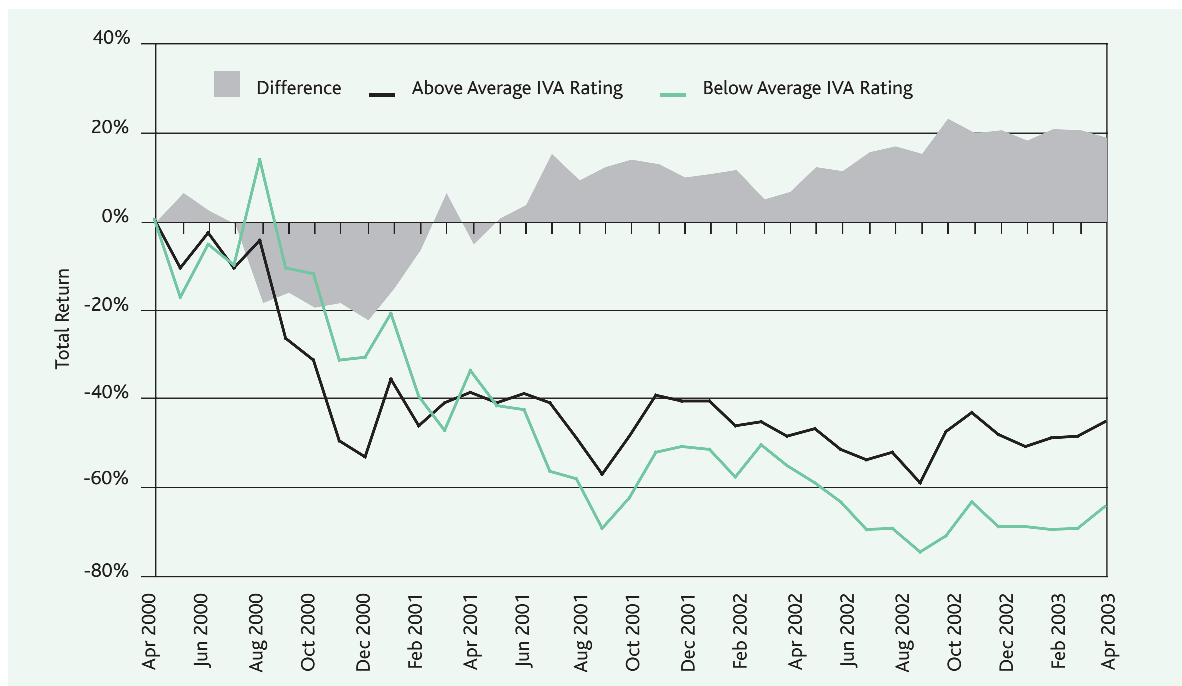
Results

There are two important conclusions for investors from Innovest's analysis, which mean the industry leaders on these issues will gain significant advantages that should be reflected in analysts' assessments:

- the financial implications of the relevant issues are growing rapidly, because of developments such as take-back legislation and competition for talented staff
- there is a wide range of competence in this field between the best and worst in the sector

In fact, past share price performance suggests a close link between management quality and the IVA rating. Over 1, 2 and 3 years the shares of the above-average scorers in the IVA table significantly outperformed those of the below-average companies, as the chart shows. Over 3 years to mid-2003 the out performance was 19%.

FIGURE 8 - STOCK PRICE PERFORMANCE FOR COMPUTER COMPANIES



Source: Innovest/Worldscope financial data

The top rated companies in Innovest's analysis, gaining an AAA rating, are IBM for environmental performance and Hewlett-Packard for social performance. Their scores are respectively 1,623 and 1,753. That compares to a lowest score of 239 in the environmental analysis and 887 in the social analysis. These wide ranges demonstrate the gaps within an individual sector between the best-managed companies and the worst – representing investment opportunities on the basis that such gaps will affect shareholder value in the medium-term.

CONCLUSION

The links between the corporate responsibility world and the City have been weak at both ends. The corporate responsibility "movement" has tended to over-generalise and overlook company-specific factors in its search for the "business case". In its turn, the financial world has been slow to take account of emerging technological, environmental and social risks which can have a significant business impact.

The actual nature of corporate responsibility is more subtle and more complex than is often appreciated. It calls for a deeper understanding - so that companies will be able to manage responsibility issues better, and investors will be better able to identify the investment implications. Companies have been getting better at identifying the key issues which are most significant for their particular circumstances, and this trend should be accelerated by the need to produce an expanded Operating and Financial Review, perhaps as early as 2005. As companies produce better information, it will be easier for investors to understand potential impacts and incorporate them into investment decisions.

The growing body of evidence on the financial impacts of socially responsible investing and corporate responsibility activity suggests several important conclusions:

- the weight of evidence does not support traditional assumptions about the negative impact on risk or returns of introducing social, environmental and ethical investment criteria. On the contrary, incorporating social, ethical and environmental (SEE) criteria can reduce volatility and increase returns
- social and environmental impacts do not fall uniformly across or within sectors – some companies are more or less exposed than others, just as with conventional business drivers
- companies are not equally skilled at managing the impacts, even if they are equally exposed
- investors and lenders, therefore, need detailed information on specific company exposures, but also their strategies and success in managing those exposures

The social, technological and economic forces which have pushed corporate responsibility up the political and business agendas show no sign of slackening. As SEE issues become more important, investors will need to take more account of them, and investment managers or advisers who fail to do so will be in danger of failing their clients.

APPENDIX: ASSOCIATION OF BRITISH INSURERS: DISCLOSURE GUIDELINES ON SOCIALLY RESPONSIBLE INVESTMENT

1. Background and introduction

Public interest in corporate social responsibility has grown to the point where it seems helpful for institutional shareholders to set out basic disclosure principles, which will guide them in seeking to engage with companies in which they invest.

In drawing up guidelines for this purpose they are mindful of statements made at multilateral level through the Guidelines for Multinational Corporations published in 2000 by the Organisation for Economic Cooperation and Development, as well as by the European Union and UK Government. These, coupled with legal disclosure obligations on UK pension funds and local authority investments, point to clear responsibilities both for companies and for institutions that invest in them.

Institutional shareholders are also anxious to avoid unnecessary prescription or the imposition of costly burdens, which can unnecessarily restrict the ability of companies to generate returns. Indeed, by focusing on the need to identify and manage risks to the long and short-term value of the business from social, environmental and ethical matters, the guidelines highlight an opportunity to enhance value through appropriate response to these risks.

It is not the intention of these guidelines to set a limit on the amount of information companies should provide on their response to social, environmental and ethical matters. Some shareholders with specific ethical investment objectives may seek more specific information. Some companies may choose to make additional information available in order to enhance their appeal to investors.

The ABI hopes that in elaborating these guidelines it will provide a helpful basic benchmark for companies seeking to develop best practice in this area.

2. The disclosure guidelines

The guidelines take the form of disclosures, which institutions would expect to see included in the annual report of listed companies. Specifically, they refer to disclosures relating to Board responsibilities and to policies, procedures and verification.

With regard to the board, the company should state in its annual report whether:

1.1 The Board takes regular account of the significance of social, environmental and ethical (SEE) matters to the business of the company.

1.2 The Board has identified and assessed the significant risks to the company's short and long-term value arising from SEE matters, as well as the opportunities to enhance value that may arise from an appropriate response.

1.3 The Board has received adequate information to make this assessment and that account is taken of SEE matters in the training of directors.

1.4 The Board has ensured that the company has in place effective systems for managing significant risks, which, where relevant, incorporate performance management systems and appropriate remuneration incentives.

With regard to policies, procedures and verification, the annual report should:

2.1 Include information on SEE-related risks and opportunities that may significantly affect the company's short and long-term value, and how they might impact on the business.

2.2 Describe the company's policies and procedures for managing risks to short and long-term value arising from SEE matters. If the annual report and accounts states that the company has no such policies and procedures, the Board should provide reasons for their absence.

2.3 Include information about the extent to which the company has complied with its policies and procedures for managing risks arising from SEE matters.

2.4 Describe the procedures for verification of SEE disclosures. The verification procedure should be such as to achieve a reasonable level of credibility.

Towards best practice

Institutional shareholders consider that adherence to the principles outlined above will help companies to develop appropriate policies on corporate social responsibility.

The principles should also provide a constructive basis for engagement between companies and their shareholders. Over time this will allow both parties jointly to develop a clear joint understanding of best practice in the handling of social environmental and ethical matters which will help preserve and enhance value. It is the intention of the ABI to continue regular contact with companies and stakeholders with a view to refining the concept of best practice.

Current understanding of best practice leads to the following conclusions and indications as to how the guidelines should operate:

1. The guidelines are intended to apply to all companies, including small and medium companies.
2. The cost of managing risks should be proportionate to their significance. Ideally, procedures should be integrated into existing management structures and systems.
3. Statements relating to the guidelines should be made in the annual report, and not separately as part of the summary accounts or on a web site dedicated to social responsibility. In view of the close philosophical linkage between these guidelines and Turnbull reporting, it would make sense to include a brief statement in the Internal Control section of the annual report, although this would not preclude a cross reference to other parts of the report where more detailed disclosure of the type of risks involved and systems for managing those risks may also fit with other content.
4. With regard to the implementation, shareholders are anxious to leave leeway for companies to establish their own systems best suited to their business. However, they believe that, with regard to clause 1.1, best practice would require the full Board to consider the issues on a regular basis, although some on-going detailed work might be delegated to a committee. Disclosure should include a brief description of the process undertaken by the Board for identifying significant risks and indicate which risks are the most significant in terms of their impact on the business.
5. Examples of initiatives for reducing and managing risks (see 1.4 and 2.2) include regular contact with stakeholders and mechanisms to ensure that appropriate standards are maintained in the supply chain. Evidence of such initiatives would be viewed positively by shareholders.
6. Reporting on performance over time in complying with policies to reduce risk will help shareholders monitor improvement in compliance.
7. Independent external verification of SEE disclosures would be regarded by shareholders as a highly significant advantage. Credible verification may also be achieved by other means, including internal audit. It would assist shareholders in their assessment of SEE policies if the reason for choosing a particular method of verification were explained in the annual report.

Questions on social, environmental and ethical matters

Disclosure could be addressed by response in the annual report to the following questions:

1. Has the company made any reference to social, environmental and ethical matters? If so, does the board take these regularly into account?

2. Has the company identified and assessed significant risks and opportunities affecting its long and short-term value arising from its handling of SEE matters?
3. Does the company state that it has adequate information for identification and assessment?
4. Are systems in place to manage the SEE risks?
5. Are any remuneration incentives relating to the handling of SEE risks included in risk management systems?
6. Does Directors' training include SEE matters?
7. Does the company disclose significant short and long-term risks and opportunities arising from SEE issues? If so, how many different risks/opportunities are identified?
8. Are policies for managing risks to the company's value described?
9. Are procedures for managing risk described? If not, are reasons for non-disclosure given?
10. Does the Company report on the extent of its compliance with its policies and procedures?
11. Are verification procedures described?

Questions for investment trusts

1. Is the voting policy of the trust publicly available?
2. Does the voting policy make reference to SEE matters?
3. Is the manager encouraged actively to engage with companies to promote better SEE practice?

NOTES

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